LAW AND CONTEMPORARY PROBLEMS

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FOREWORD

This symposium deals with the first three years' experience under the Federal Securities Act. Part I was published in the January 1937 issue of this periodical. This issue presents the second and concluding part. The general scope of the symposium, as was explained in the foreword to the previous issue, is to indicate in broad outline the general objectives of the Federal Securities Act, to describe the administrative machinery used to accomplish its objectives, to note the readjustments which the Act has made necessary, and to appraise the degree of its success from various points of view. Although the table of contents of Part I is presented on the succeeding page, it may not be inappropriate here to sketch briefly the subject matter of its articles for the benefit of those who have not seen the issue containing it.

The symposium was introduced by an article explaining the organization and functions of the body used to administer the Act—the Securities and Exchange Commission. This was followed by a study of securities registrations under the Act, including, among other things, the amount and type of securities registered, the kinds of industries seeking registration and the costs of preparing registration statements and of distributing securities. A third article presented a specialized study of proposed investment trust and precious metal mining issues which failed of effective registration, of the investment quality of such issues, and the reasons for their failure. Two articles dealt with the effect of the Act upon investment banking methods. The first of these not only described the mechanics of security flotation before and after the Act's adoption but also presented statistical analyses of the types of flotations, the types of buyers, the volume of private placements, and kindred matters since that date. The second laid special emphasis upon the problems encountered under the Act by the investment banker and security dealer. The fifth article presented an appraisal of the Securities Act from the point of view of the institutional investor—insurance companies and banks. The concluding article dealt with legal problems which have arisen in connection with the exemption from the Act of certain types of securities, such as those of banks, railroads and state and municipal issues, and with the exemption of certain types of transactions involving the sale and distribution of securities.

The first four articles of Part II, which comprises this issue, deal with the problems presented by the Act which are encountered by the issuer in seeking to meet its requirement of full disclosure, by counsel who is called upon to supervise the

intricate processes of registration, by the accountant who must provide much of the data requisite therefor, and by those engaged in the reorganization of corporations. Then follow two articles discussing the relationship of the Securities Act to two other important bodies of legislation impinging on the same field: the state "blue sky" laws and the Securities Exchange Act of 1934.

WARNER FULLER.

THREE YEARS OF THE SECURITIES ACT—PART I

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FULL DISCLOSURE UNDER THE SECURITIES ACT

BRUNSON MACCHESNEY* AND ROBERT H. O'BRIEN†

The Securities Act of 1933 was passed to correct some of the abuses that had arisen in the distribution of securities. The popular name, the "Truth in Securities Act," aptly characterizes its essential purpose. The Congressional mandate embodied in the Act calls for full disclosure of many more facts than were normally revealed to the investor. The validity of this mandate will in large part be determined by the wisdom with which the Securities and Exchange Commission administers its provisions.

All persons seeking to use the mails or means of interstate commerce for the disposition of securities must file a registration statement with the Commission. A prospectus based on the registration statement must be given to the investor prior to any offer of sale. The Act authorizes the Commission to adopt rules and regulations governing registration statements and prospectuses for various classes of securities and issuers. These rules and regulations prescribe the form or forms in which the required information shall be set forth, and methods to be followed in the preparation of financial statements and reports or valuations by experts. The information required to be furnished in these documents is guided by Schedule A of the Act, which sets forth the type of disclosure envisaged by Congress.

All the forms rest fundamentally upon Schedule A of the Act. The emphasis of the form with respect to the information sought varies with the type of business, or nature of the security, or the circumstances surrounding the issuance of the particular security. While the requirements vary somewhat from form to form, what is said of any particular form is accurate to a large degree as to all forms. To reduce the area of discussion, comments on the forms and instances of disclosure will be confined to Forms A-1 and A-2. These forms have made available information which prior to the Act was unavailable except incompletely in letters to stockholders, yearly reports and financial manuals.

Form A-1 is used for the most part by companies in the so-called promotion stage.

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In the typical case, the issuer is without any significant history as a going concern. The form emphasizes consequently the disclosure of the nature of the physical property in connection with which activity is to be conducted, various costs and charges to be assessed against the proceeds from the sale of securities such as underwriting commissions and bonuses, payments to promoters, payments for property, and the plan of business operations. Form A-2, used by so-called seasoned companies, requires information somewhat comparable to that reflected in Form A-1, but the emphasis is shifted to the financial statements reflecting both the present status of the enterprise and the results of operations for several years prior to the filing date. The financial statements, essential for the use of A-2, furnish more adequate disclosure than some of the detailed data required in A-1. For this reason, the requirements for some of the items in A-2 have been relaxed. The financial information, together with the information in narrative form in response to the items, give a reasonably adequate aggregate of data from which the degree of probability of continuity of the same trend may be estimated.

It is true that to some extent the picture presented in a registration statement and prospectus is incomplete. Many of the imponderables, such as the background of world conditions, and the factor of personalities and managerial skill, are not called for in the forms. The information required covers only a relatively brief period of the business history prior to the date of filing and the status of the business as of that date. The registrant is not expected to make prophecies concerning the future. Indeed the Commission has issued stop orders where prophecies involved clear misstatements of matters of fact. But the basic data essential to the exercise of a sound judgment, apart from general business conditions, should enable the investor to project the chances of success of the venture and to reach a reasonably accurate conclusion as to the value of a given share.

The data and information supplied in the forms may not be entirely valid or trustworthy for one of several reasons. The issuer may misconceive the meaning either of a particular word or a particular item. The misconception may result in either a minor technical deficiency or it may operate to dislocate the symmetry and the integration of the internal structure of the registration statement. Presumably, a person need give no information beyond that required by the form on which the particular securities are registered, except as procedural sections of the Act, prohibiting the omission of any statement without which the statements made are misleading, may create such an obligation. That is, one might give all the information required by the form and yet not have satisfied the requirement of full and fair disclosure. The effect of this is not merely to insist that each item as answered state the full truth, but that all the items answered fully in this sense must not give a misleading picture of the enterprise as a whole.

This is strikingly illustrated in the *National Educators*[1] case. The filing of amendments to correct deficiencies in the answers to individual items led the Com-

[1] 1 S. E. C. 208 (1935).

mission to discuss its power to challenge a filing because it was misleading as a whole. The Commission in its opinion wrote:

". . . As we have said before, our powers do not extend to preventing the public offering of a security if the truth concerning it be told, but the truth, under the Congressional mandate embodied in the Act, means the full truth. (Cf. *In the Matter of Plymouth Consolidated Gold Mines, Inc.*, 1 S. E. C. 139, June 1, 1935). The registration statement seeks to ascertain certain very definite particulars of a registrant. In many instances, answers to these may be technically adequate when viewed item by item. The combination of these items, especially those required to be set forth in the prospectus, generally reveal the character of the offering being made and the nature of the security the investor is being solicited to buy. But it may frequently be true that the cumulative effect of these individual items is carefully and intentionally concealed by their segregation in the prospectus, with the result that the impression left upon the reader by the prospectus is fundamentally untrue and misleading. The challenge of the Commission can thus under the Act be not only to individual items in the registration statement and prospectus as such, but upon the broad basis that the general effect of the prospectus as an entirety is to create an untrue and misleading picture in the minds of prospective investors. Frequently the prospectus, which is and should be a selling document, attempts to summarize in broad terms the nature of the offering. If this summarization is untrue, it can undoubtedly be challenged by the Commission. But even where there is no such summarization, the circumstances of a particular offering may well be such as to make the absence of statements setting forth in simple language the consequences of certain features of the financial structure of the registrant have the effect of portraying an essentially inadequate and misleading picture to the investor."

This opinion makes explicit the mandate implicit in the Act that the whole truth should be told. No subtle distinctions ought to avoid the clear necessity that those seeking other people's money should be completely frank about the enterprise in which the investor is urged to participate. Protection of the investor to this extent is certainly a minimum under the Act. Will such protection of the investor succeed in partially solving the problem of control of abuses of security distribution? The Commission in its administration of these provisons of the Act looking to full disclosure has developed techniques and policies which bear promise of success. Their significance becomes clearer in relation to their development. This development is best illustrated piecemeal. After something of a "Cook's Tour," we may be better able to gauge the extent of the new protection the investor is receiving.

I

PROMOTERS

The promoter has been a key figure in the development of the Commission's policy as to full disclosure. The large number of small enterprises in the mining and brewery industries that have commenced business since the passage of the Act has led to fuller adumbration of the ambit of the statute as a by-product of dealing with the problems raised by their registrations. Much that has been decided will be of value when larger businesses of different types seek new funds. These latter

enterprises have largely engaged in refunding operations, and are usually able to come within the requirements for the use of Form A-2. Payments to promoters are not of such great significance in this type of enterprise, and the form itself cannot be used if prior promotion payments have been excessive.[2]

In a new corporation, on the other hand, the share of the promoter is of special interest and significance as the percentage of dilution of the stock for promotional payments is apt to be great. Form A-1 is designed to force disclosure of the promotion process so that the investor may know what he is paying for this type of service. The form when answered properly will bring out the names and addresses of the promoters, the stock interest, whether beneficial or of record, payments to promoters and the nature of the consideration given therefor, a statement of the intention of such persons with respect to subscription to additional stock and the prices at which such subscriptions will be executed, and details of any property purchases already made from promoters and any property purchases to be made by use of the proceeds of the issue registered. The Commission has, in many instances, compelled the identification of certain payments ostensibly going to an individual not named as promoter, or disguised as a payment for tangible assets, as promotional payments. Administration has made these requirements of disclosure not merely formal. A superficial statement of what has been given and what has been received is not enough. The real character of the promotional operation must be clearly presented. This insistence on reality is present both in the cases decided without opinions as well as those in which an opinion has been published. The opinions, however, make clear the basis for the other rulings.

To date, the Commission has made no definitive statement of the type of participation or activity which will render one a promoter. The accretion of its rulings in this connection indicates quite definitely, however, that its concept of "promoter" does not vary significantly from the common law doctrine. It may be said without attempting to predict possible extensions of the rule that one who participates actively in bringing about the formation of a corporation or one who participates actively in the launching of the enterprise after its formation will be deemed to be a promoter.

The Commission has brought about the disclosure of promotional payments, originally suppressed in the registration statement, by finding persons not named as promoters to be promoters. Payments to them are, therefore, payments to promoters and fall within the scope of the item seeking to elicit information concerning payments to such persons. Thus, in the *Continental Distillers* case,[3] the chief promoter's law partner collected a commission on the sale of the property to the registrant. The Commission held he was a promoter and should have been named as such. In the *Gold Hill* case,[4] 300,000 shares were issued to one man for promotional services. The omission to name this man as a promoter was held a material omission. It

[2] One of the rules for its use denies the privilege to one otherwise entitled if promotional payments within a certain period prior to filing have been in excess of a certain amount.

[3] 1 S. E. C. 54 (1935).

[4] Securities Act Release No. 1036, Sept. 16, 1936.

should be noted that this item calls not only for payments for promotion service *per se* but for payments of any character to promoters. The crux of the requirement is to identify precisely the character of the payment so that the investor may know what amount the promoter has received purely for promotional services, as well as identifying payments of other amounts in different transactions.

In the *Snow-Point Mining* case[5] certain persons who acted as promoters of the issuer were not named as such. The Commission held a hearing in the matter and wrote an opinion embodying its findings of fact on the evidence. The evidence showed that an item on the balance sheet in the amount of $260,000 represented by 260,000 shares of stock of par value of $1.00 and designated as promotional services, was due, not, as stated, to the only person named as promoter, but to four individuals, all of whom participated in the promotion of the registrant. The shares were allocated to these persons, not on the basis of a fair appraised value of the services rendered, but in accordance with a preincorporation agreement made between the four individuals, promoters, providing for a division of the authorized shares of the corporation to be formed. The Commission found in this case that the statement that $260,000 represented payment for promotional services was false in the light of the origin of this figure in the preincorporation agreement. It was quite clear from the evidence adduced at the hearing that promotional services of that value were not rendered and that the promoters, who, subsequently, acting as a board of directors, adopted resolutions awarding themselves these shares, made no *bona fide* finding that promotional services of any particular value were performed in behalf of the corporation. Their primary purpose was to obtain control of the company.

This same disregard of the future investor is illustrated by the opinion in *Matter of Franco*.[6] The promoters in that case admitted the stock was issued in accordance with a preincorporation agreement. They represented that the consideration for the issuance of 150,000 shares with "stated value" of ten cents a share was the transfer of a lease-purchase agreement, which testimony at the hearing disclosed had been acquired by the promoters for no consideration. The Commission held that the omission to disclose this information called for by the form, as well as the representation of "stated value," was misleading.

A case which illustrates strikingly the adept handling of literal statements descriptive of payments to promoters, which through lack of precision and identification create a misleading picture, is the opinion of the Commission in the *Brandywine Brewing Company* case.[7] The statement as originally filed recorded on the balance sheet the item "property $100,000." The Commission raised a question as to the truth of this $100,000 valuation placed on the Brandywine property in the registrant's balance sheet as originally filed. As a result, the registrant filed an amendment to its registration statement containing a new balance sheet certified by a different firm of accountants and carrying the property at $29,000, and promotional expense at

[5] 1 S. E. C. 311 (1936). [6] 1 S. E. C. 285 (1936). [7] 1 S. E. C. 123 (1935).

$71,000. The truth of this balance sheet was put in issue at the hearing. The Commission, contending that the figure $71,000 for promotional service involved primarily a representation that services fairly and reasonably worth that amount were rendered, reviewed the evidence concerning the extent and nature of the services rendered by the promoters and concluded that the item of $71,000 in the balance sheet for promotional services constituted a misstatement of a material fact and held that a large portion of this stock was in reality donated to the promoters and not issued for services as stated, and should have been so identified.

Cases involving more brazen overvaluations clearly fall within this principle. Thus, in the *Haddam Distillers* case,[8] the valuations were admitted to have been padded in order to disguise promotion payments. This same device was attempted in the *Unity Gold* case.[9] In *Continental Distillers*,[10] a promise on the part of promoters to spend $50,000 in improvements, the binding character of the promise being far from clear, was included in the "cost" of property. In the *Plymouth Gold Mine* case,[11] an omission to disclose that the president, the chief promoter, had bought the property at a tax sale, was misleading, as it is this contrast between cost and valuation which is so illuminating to the investor. Similarly in *La Luz Mining*,[12] the promoters did not reveal the consideration they paid for the stock of another corporation which they exchanged for stock of the registrant. The failure to disclose preincorporation agreements in *Franco Mining*[13] and *Snow-Point Mining*[14] has already been noted. In the *Great Dike Mining* case,[15] the statement that a lease and option agreement was the consideration for the stock issued to promoters was untrue. The hearing showed that the lease and option had been acquired by the promoters at no cost to themselves, as in *Matter of Franco*.[16] In the recent case of *Mining and Development Corporation*,[17] the promoters attempted to include cash advances, previously made, as part of the cost of property sold by them to their corporation.

Frequently, the presentation of the present status of a registrant and its history is complicated by the fact that formal action to a certain end will have been taken by the issuer's board of directors in connection with the value to be placed upon assets and the consideration received by the corporation in exchange for issuance of shares of stock. In several of the cases just discussed this was the method used to disguise promotional payments. Should the Commission allow this formal action to serve as a screen for such payments? The courts of many states hold that the action of a board of directors in placing a value upon particular assets of the corporation, in the absence of bad faith or fraud, will insulate against successful actions by creditors or stockholders based upon stock watering theories of liability. The Commission, however, accepts statements concerning action by the board of directors

[8] 1 S. E. C. 37 (1934); 1 S. E. C. 48 (1935).
[9] 1 S. E. C. 25 (1934).
[10] *Supra* note 3.
[11] 1 S. E. C. 139 (1935).
[12] 1 S. E. C. 217 (1935).
[13] *Supra* note 6.
[14] *Supra* note 5.
[15] Securities Act Release No. 954, Oct. 5, 1936.
[16] *Supra* note 6.
[17] Securities Act Release No. 1090, Oct. 22, 1936.

only to the extent that they purport to reflect that the board of directors as a matter of form has made the pronouncements and reached the conclusions expressed in the resolution, but refuses to accept the statements as establishing the truth of the conclusions stated.

The *Unity Gold* case[18] presented this issue squarely. A lease and option on mining property was transferred by one corporation of the promoters to the Unity Gold Corporation in exchange for $5,000 cash and 599,995 shares of common stock, par value $1 per share. 475,000 of these shares were immediately "donated" back to Unity Gold's treasury, pursuant to agreement. The purpose of this transaction was to make these "donated" shares valid treasury shares which could be sold at less than par as non-assessable stock. But these shares were included by the promoter-directors as part of the cost of the lease and option. The Commission challenged the inclusion of such "donated" shares as part of the cost. Despite the validity of this device to make the shares fully paid and non-assessable in the state where this corporation was chartered, the Commission held that, "under the standards of truthfulness demanded by the Securities Act," their inclusion as part of cost was untrue and misleading.[19] The effect of this decision was not only a more truthful statement of cost but the elimination of a fictitious surplus from the balance sheet.

This same policy of penetrating the veil of directors' motions has been pursued in other cases. In *Continental Distillers*[20] the valuation of the property as equivalent to the stock issued to the promoters was challenged when this valuation was greatly in excess of the price paid in a recent transfer. In *American Gyro*[21] the directors had arbitrarily valued an untried invention as worth $260,000 in "good will," although good will is clearly misapplied in such a case. In *Mining and Development Corporation,*[22] the Commission, after finding that the first alleged basis of valuation was invalid, held that an amendment, made with knowledge of such invalidity, that retained the same figure with a footnote stating it was not present value was still untrue and misleading.

Another aspect of the Commission's treatment of promotion problems is the compelling of disclosure of various selling schemes. In *Gold Producers,*[23] the representation that the stock was being given away to investors, when the stock was assessable, was held untrue. In *Plymouth Gold Mines*[24] the promoters made a similar appeal to the bargain-hunting instincts of the investor. The investor was led to believe that the payment of an additional small sum would salvage his original investment with the same promoters. The Commission held that a price of stock, which included the worthless old shares as a substantial part, was misleading. A "chain selling" scheme was the device of the promoters in the *Wee Investors* case.[25]

[18] *Supra* note 9.

[19] It will be noticed that the misleading consequences of this entry are reflected by the contra entries necessarily made to Capital Surplus.

[20] *Supra* note 3.

[21] 1 S. E. C. 83 (1935).

[22] *Supra* note 17.

[23] 1 S. E. C. 1 (1933).

[24] *Supra* note 11.

[25] 1 S. E. C. 202 (1935).

The Commission held that it was misleading in the absence of disclosure that only a few out of many potential investors could profit in the manner alleged.

The investor was courted by a "stockholders' protective plan" in the *Oil Ridge Oil and Refining* case.[26] The promoters claimed that thirty percent of the investment would be withheld from the oil venture and invested by the promoters so as to equal the original principal at the end of twenty years. At the end of this time, the investor could elect between the result of his oil venture and his "investment." The Commission pointed out that the investor himself could match his own investment in a similar ratio and not have to elect between them at the end of the period. To characterize this as a protective plan having a "bond" feature and "guaranteeing" the principal was held grossly misleading.

The selling device of a "step-up" in price, which enables the salesman to urge the investor to get in before it is too late, was employed in the *Snow-Point*[27] and *Avocalon Extension*[28] cases. The Commission found in both instances that the "step-up" had no relation to increases in value of properties behind the stock, and that the arbitrary increases were, therefore, misleading.

This discussion of the promoter illustrates the method of the Commission. The emphasis is on identification of the charges for promotion so that the investor may judge their worth. To disclose these charges, the various elements serving as a basis for comparison must be marked for what they are.

II

UNDERWRITERS

A similar emphasis on proper identification of the underlying elements in the investment picture marks those portions of the registration forms relating to underwriting and distribution. Copies of underwriting contracts must be filed with the registration statement as exhibits, but the Commission intends these more for the use of its own trained examining staff than for the perusal of investors: they are not required to form part of the prospectus. Here as elsewhere, the Commission recognizes that the sheer length of carefully drafted financial documents discourages the average investor from reading and understanding them. Hence the registration form includes items requiring a brief but explicit summary of the salient features of the arrangements for distribution, and in the examination process their adequacy is checked against the documents themselves. These items demand a statement of the price at which the underwriter is to take the securities, the price or prices at which he proposes to sell them to the public, together with full details of his own profit and of the participations he will allot to distributors and "finders." If preferred lists exist, the form will show their existence and nature, unless there is deliberate concealment or misstatement, for one item requires identification of those to whom the securities may be offered at any price varying from that at which the

[26] 1 S. E. C. 225 (1935).
[27] *Supra* note 5.
[28] Securities Act Release No. 1005, Aug. 26, 1936.

public is invited to buy them. Other items, asking that all persons affiliated with the management indicate whether and at what price they intend to subscribe to the securities, supplement the disclosure of preferred lists on Form A-1 and at the same time may give the investor some indication of the confidence which the moving persons in the enterprise repose in it.

Where such insiders already possess substantial blocks of securities of the same class as those being registered, the Commission exercises an especial vigilance to insure the investor against undisclosed distortion of the market at the time of flotation. Thus, the Commission insists that the prospectus reveal the existence, and a summary of the terms, of any agreements restricting or preventing the sale or disposition during the distribution period of securities of the same class as those underwritten. This type of agreement, commonly characterized and referred to as a "stand-off," operates to diminish the supply of the particular securities at the exact time an intensive effort is being made to stimulate demand and puts the underwriter in position of regulator. The probable effect on the price is quite obvious. Similarly, when securities are stated to be offered at "the market," the issuer is required to state what market is meant and give a description of the nature of the market involved and the extent of his own activity or the activity of underwriters or dealers in such market.[29] The position of the underwriter is thus clearly revealed.

III

PERSONS RELATED TO THE ISSUER

A. *Experts*

The development of the Commission's rulings in connection with experts has been a most interesting one. There have been two distinct lines of inquiry. One has been the disclosure of the interest of the expert in the issuer, and, as a corollary thereof, the "independence" of such an expert in the situations where independence is required. The other development has been one of testing the methods employed and results attained by experts, and even delineating the minimum standards necessary for that status.

(1) "Interest" and "Independence"

The forms are so designed that the validity of the information supplied or the reliability of any expression of opinion contained in a registration statement may be appraised with knowledge of the existence of an interest of any expert on whose authority such statements are made or any interest of an expert whose statements or expressions of opinion are used in connection with the registration statement or prospectus. Likewise, the integrity of any transaction may be estimated with knowledge of an existence of a colorable relationship by a participant in such transaction with the registrant. The Act itself requires that the financial statements shall be certified by an independent public accountant. The theory of the Act is that an

[29] See, in this connection, Section 9 of the Securities Exchange Act of 1934.

investor should not be left to rely on the conscience of an accountant preparing the financial statements, but should have at least the expression of his judgment without the color of an interest in the aims and progress of the issuer.

The opinion of the Commission in the *Plymouth Consolidated Gold Mines, Ltd.*, case[30] illustrates the type of relationship or anticipated relationship which the Commission deems to be an interest of an expert in the issuer which should be disclosed in the registration statement and prospectus. In that case, the registration statement contained a report by a mining engineer. The evidence at the hearing disclosed that this particular engineer was hopeful of obtaining employment with the issuer when its mines were put in operation, and showed further that at the time of making his report this engineer was general manager of the properties of a predecessor during a former period of operations. The Commission held that the inclusion of these facts came within the general ambit of disclosure called for by the item.[31]

The question of independence was presented squarely in the stop order proceedings relating to *Cornucopia Gold Mines*.[32] The financial statements in that instance were certified by a person who was an employee of the firm of accountants certifying to the financial statements, but he likewise acted as comptroller for the registrant under the terms of a contract between the registrant and the accounting firm. It was conceded that the financial statements truthfully and accurately reflected the status of the issuer, the only issue being the independence of the certifying accountant. The Commission reviewed the evidence which showed, among other things, that the accountant whose independence was in issue received no salary from the registrant but received his remuneration entirely from the firm of accountants. It was established, however, that, at the time the registration statement became effective, he was exercising the usual functions of a comptroller with authority over registrant's employees regarding accounting matters, signing mail of the issuer and also having authority to sign checks with another officer. The evidence further disclosed that he owned 1,760 shares of stock of the issuer which he had paid for with cash prior to the filing of the registration statement.[33] The Commission concluded that it was unreasonable to suppose that the accountant under these circumstances would cast aside these relationships and view the accounting principles with the objectivity of an "independent" accountant, criticizing and correcting accounting practices and methods of the corporation's own staff. In making an audit, he would be in fact reviewing his own work. It was held that the existence of these disabilities prevented

[30] *Supra* note 11.

[31] In the Great Dike case, *supra* note 15, the accountant who certified the statements, except for receipts and disbursements, was employed on a contingent fee basis. He admitted that his methods and results were not to be relied upon.

[32] 1 S. E. C. 364 (1936). It was also held in this case that the failure to disclose the interest was an omission under Item 50—an omission of the type discussed in the text in connection with the Plymouth case, *supra* note 30.

[33] The mere existence of an interest does not destroy independence. The Commission said in its opinion in the instant case "A continuing pecuniary interest which an accountant has in a registrant may be so small or so indirect as to give rise to no inference that the accountant has lost or is likely to lose that objectivity which is implicit in the concept of an "independent" accountant.

him from being an independent accountant. As the company had filed amendments subsequent to the date of initiation of stop order proceedings, including financial statements certified by an accountant admittedly independent, the Commission, as it may within its discretion, dismissed the proceedings without issuing an order.

The demand for independence is even more clearly illustrated in the recent opinion in the *American Terminal and Transit*[34] case. The accountant in that case, despite certification, which the Commission had held in the *Cornucopia*[35] case to be a material fact, had recorded in the balance sheet as cash an item that was an overdraft on the books of the company. The Commission found this to be an untrue statement of a material fact. This falsification, however, led the Commission to find that an inference of absence of independence should be drawn. The opinion pointed out that there was no relationship of the type discussed in the *Cornucopia* case, but that the standards of the Securities Act demanded that "independent" experts approach their task with complete objectivity free of any entangling alliances, and that falsification of this type, for whatever motive, destroyed the basis for an inference of independence.

(2) Standards and Qualifications

The Commission, as has been stated, has not only insisted on disclosure of the interest of an expert and real independence when independence was required, but it has also gradually delineated the standards, methods and integrity necessary for one to hold himself out as an expert.

It is patent that all the information in the registration statement cannot be based upon expert opinion or knowledge. The determination of what information may be given upon the authority of an expert and what information must be supplied by the issuer itself is a matter of day-to-day routine of examination of registration statements. Assuming that the subject matter covered by the expert is of a type or kind properly susceptible of treatment by an expert, what are the standards set up by the Commission by which the validity and accuracy of the expert's conclusions will be tested? The Commission in the *Haddam* case[36] stated that valuations contained in an appraisal purporting to follow certain norms are representations that these norms have been accurately and fairly followed. If the norms purported to have been followed are not fairly observed, the valuations finally arrived at are in essence misrepresentations of fact because they untruthfully describe the basis upon which the valuations are made. In *Big Wedge Gold Mining*[37] the Commission held that a mining engineer's report on ore bodies which neglected fundamental principles of scientific method and disregarded obvious and known facts and also disregarded the standards he expressly or impliedly purported to follow constituted a misrepresentation of fact. Thus it becomes clear that the Commission will, in connection with any report prepared by an expert, insist that the conclusions ex-

[34] Securities Act Release No. 1066, Sept. 29, 1936.
[35] *Supra* note 32. [36] *Supra* note 8. [37] 1 S. E. C. 98 (1935).

pressed in the report be based upon an exercise of technique and procedure common among the class of experts with which he identifies himself. It will be noted that in both these cases the Commission criticized the report on the ground that the method impliedly followed in reaching conclusions had not, in actuality, been followed. The Commission's action in these two cases represented a challenge of both the method and result of the appraisals.

A variation of the Commission's action with respect to experts is represented by its opinion in the *La Luz Mining Corporation* proceeding.[38] The registration statement included a report by one Professor Haas, described by registrant as a scientist and geologist of world-wide renown, and the inventor of the "mineral indicator." While no thoroughgoing description of the mineral indicator was set forth in the registration statement, it turned out at the hearing subsequently called that the mineral indicator was a cylinder suspended from a leather thong, by which the professor claimed to be able, with uncanny accuracy and precision, to estimate the length, depth, width and average value of mineral veins. It appeared that the professor had been a horticulturist until ten years before the date of the hearing, at which time he discovered and constructed his mineral indicator. Two expert witnesses produced by the Government testified that the professor's mineral indicator fell within the class of devices known as "doodle bugs," and both were quite positive that this method of prospecting for ore-bodies was ridiculous. The Commission, in its opinion, characterized the method as ludicrous, but did not pass upon the qualifications of Professor Haas in the matters in which he was held out as an expert. There was no room for criticism of Mr. Haas for deviation in application of recognized "mineral indicator" principles as Mr. Haas, being discoverer of this method of locating and evaluating ore bodies, unquestionably adhered to the standards of his own creation.

These three opinions taken together establish that the conclusions of value reached by an expert may be challenged by the Commission either because the method is unsound or because of failure to adhere to norms impliedly followed, or, aside from principle and method, because the result expressed is inaccurate. It is only inferentially that the Commission has, through these opinions, passed upon and expressed an opinion as to the qualifications required to be possessed by an individual before he may be held out as an expert.

In the recent case of *Gilpin Eureka Consolidated Mines*,[39] the Commission made explicit the necessity that an expert have the normal skill of his profession and follow the procedures usually employed. The prospectus in that case stated that the president had been an engineer for the Austrian Government for four years, and that he had been, for the last three years, engaged in mining engineering. The evidence disclosed that his Austrian experience consisted of driving and overhauling locomotives for the government-owned railroad, and that his mining training ranged

[38] *Supra* note 12.
[39] Securities Act Release No. 1078, Oct. 13, 1936.

from the reading of textbooks to conversation with mining people. The Commission, therefore, held that these representations of expertness were misleading, and in its opinion said:

"The qualifications which characterize the expert are not rigid and categorical. Certainly training, integrity, intelligence and experience are among them. We do not attempt to present a precise scale for the measurement of these qualifications. It is equally certain, however, that one truly an expert brings to his work knowledge and skill which are the substance of his profession and which are evinced by his use of the principles and procedures normal to others in his field, and we can and do take the position that by the failure to employ such normal principles and procedures the absence of the requisite knowledge and skill is disclosed."

B. *Insiders, Directly or Indirectly Related to Issuer*

The items of the forms are so correlated and integrated that, assuming accurate and complete answers, past uses of the issuer's assets to the direct or indirect benefit of the insiders will be shown. The story may become evident from the answer to a single item or from the combined answers to several items. Ordinarily, examination technique forces disclosure of motives of self-profit and unusual payment through the citation of deficiencies on issuer's statement of the business done and intended to be done, the statement of underwriting commissions and other expenses incurred or to be incurred in the course of the sale of the issue, the uses to which the proceeds are proposed to be put, property purchases already made and those to be made out of the proceeds of the issuer, the statement of stock ownership which discloses sources of control not evident from the formal statement of the directorate, and management and promotional payments.

An interesting illustration of the exercise of administrative powers to bring about disclosure of facts originally concealed or misstated is the Commission's opinion in the *American Gyro Company* case.[40] It was represented in the registration statement that the company was organized for the purpose of conducting experimental work in connection with certain inventions, particularly in development and construction of a so-called gyro-plane. One H. M. Little was shown to be in control of registrant and to have been the dominating figure in all its financial operations and in its management. The evidence at the hearing established that Mr. Little was likewise the promoter and dominant person in a company engaged in the printing business and a company engaged in gold mining and in a third company organized for the coal and coke business, whether or not it was actually engaged in it. The Commission found among other things that "The registration statement not only failed to make the specific disclosures set out in the trial examiner's report to show that moneys coming into the registrant's possession were not being applied in accordance with representations, but it failed completely to show that these uses of the finances of the company for purposes other than those represented in the

[40] 1 S. E. C. 83 (1935).

registration statement were actually for the benefit of Little, who was one of the promoters of the company."

IV

MANAGEMENT AND CONTROL

Disclosure under this head emphasizes information hitherto all too frequently slighted. The stock-holdings, not only of the official management, but of those who may exercise real control through stock ownership, are demanded. The interest of such persons in property acquired within two years or to be acquired must be revealed. The remuneration of directors, principal officers, and other "insiders," management and supervisory contracts, the names and addresses of directors and officers, and a brief description of the business experience of the principal officers during the last five years complete the requirements in A-2.

In the *American Credit Corporation* case,[41] the registrant stated that "the character and history of the management should assure the success of the company." The evidence at the stop-order proceeding, however, would convince even the credulous that this was something less than a mild overestimate of their own ability. The chief promoter was one Henry Girola, who had been the principal figure in other investment companies. The facts were that these investment companies had gone into receivership and bankruptcy, and their earnings statements were falsely compiled, losses being shown as investments and operating expenses added to cost of stock of subsidiaries. While in such condition, sales literature misrepresenting the status of one prior company caused the Corporation Commission of California to revoke the permit to sell. Representatives of the California Corporation Commission testified that no permit to sell would be issued to any company under the management of Mr. Girola. The prospect of such management as Mr. Girola had furnished in the past was not reassuring. To state that such management promised success was obviously misleading.

The best evidence of the caliber of management does not often arise so directly. The matters dealt with in this paper under other headings speak volumes on the character of management the investor will receive. Lengthy statements on the character of the management would serve no purpose. Failure to live up to the standards of a fiduciary, an obligation which the solicitation of other people's money implies, carries its own condemnation.

V

DISPOSITION OF THE PROCEEDS

All the forms require the detailed statement of the purposes to which the proceeds of the issue registered will be devoted and the approximate amount for each such purpose. In the case of established businesses, the issue registered is being sold for the purpose of obtaining funds for working capital and a detailed break-down is

[41] 1 S. E. C. 230 (1935).

frequently impossible. However, in these instances, the availability of other information in the registration statement, descriptive of the nature of past operations, and the probability of continuity of operations of the same character should enable the analyst to determine with fair accuracy the general uses for the proceeds. In a new enterprise the proposed use of the proceeds is of greater significance. The examination technique in this connection is to cite the deficiencies in every statement in which information concerning the proposed uses of the proceeds is not correlated to and integrated with the statements concerning the nature of the business done and intended to be done. Invariably, the registrant is required to describe the plan of business operations if the statement of uses of the proceeds is based upon any considered plan of operations. The break-down into detail of separate purposes is not only required but the Commission's technical experts check the adequacy of the separate amounts stated for each purpose. Thus, in the *American Kid Company* case,[42] it was stated that $100,000, out of $450,000 to be raised, was to be used for working capital. This was shown to be out of line with the experience of the industry. Even though amendments revealed an intention to supplement this amount by the use of letters of credit, which would be prior to the securities, the Commission held it to be misleading in the absence of explanation to record estimates materially out of line with the industry. The various estimates for costs were likewise out of line with similar conditions in the industry and so were held misleading when not justified.

The registrant is required to state the priority of application of the proceeds to each individual purpose, and, if the plan is one which can be successful only if the entire amount be raised, the registrant is required to make such a statement and a declaration of its intention with respect to disposition of the proceeds in such event.

Certain registrants have attempted, by giving a thorough-going detailed answer to Item 27, to create the picture of a thriving prosperous enterprise. However, details can be overdone and can mislead rather than inform. The Commission requires only such information as the registrant is in a fair position to furnish, and, if the registrant is seeking an amount of money from the public, a portion of which it has no present need for and does not know what to do with, the truth of the situation requires that it say so. Thus, in the stop-order proceeding relating to *Gold Shore Mines, Ltd.*,[43] the trial examiner found that the statement concerning proposed uses of the proceeds of the issue was misleading in its representation that the registrant was in a position to predict the uses of the proceeds, whereas it was actually in no such position. The facts showed that the issuer was a recently organized mining company which owned an extensive area along the shores of Lake Winnipeg, Canada. The issuer proposed to explore for commercial gold and develop whatever deposits might be encountered. The evidence at the hearing showed that only a slight amount of exploration work, consisting of a few shallow

[42] Securities Act Release No. 1061, Oct. 1, 1936.
[43] No Commission opinion was written.

surface pits and cuts at irregular intervals along the course of the vein, had so far been completed. Expert testimony was introduced to the end that no mining engineer could, in view of the undeveloped character of the property, so perfectly and precisely allocate definite sums to particular purposes.[44]

The registrant subsequently amended its statement in a manner to make clear that an amount of money far in excess of the issuer's present needs was being raised, and to disclose that possibly the entire amount would never be needed, as the initial exploratory work might not result in the discovery of any commercial ore bodies. The issuer likewise stated in its amended statement its proposal with respect to the disposition of the remaining proceeds assuming unfavorable results from the exploration work.

This same omission to disclose the possibilities and effects of failure upon the disposition of the proceeds is further developed in the *Mining and Development* case.[45] The promoters in that case had an interest in a Bolivian mine. They obscured the export and exchange restrictions obtaining in Bolivia which vitally affected their estimate of profits, as well as casting doubt on the possibility of operating the mine at all. Furthermore, the status of litigation with respect to the Bolivian property was such that the registrant might have no interest at all, or, if they did have an interest, it might be only as a lessor for some years. In connection with another property, the promoters did not disclose that sufficient proceeds had to be raised to pay off their own prior claim before the property became available for operations.

The misleading character of excessive detail as to use of proceeds when such certainty is not possible, noted in the *Gold Shore Mine* case,[46] was likewise challenged in the *Snow-Point Mining* case.[47] But general statements as to intended use when details should and could be furnished are likewise misleading. Thus, in the *Lewis American Airways* case,[48] the Commission held that the registrant, in answer to the item, must disclose some program from which the investor may judge the investment possibilities.

VI

CAPITALIZATION

The items relating to the capitalization of the registrant are designed to make clear the rights that the investor will acquire. In Form A-1 this is less thoroughly developed. The rate of dividend and method of payment in the past, the present

[44] The expenditure of the $600,000 net proceeds (except for certain sums for selling expenses) to be derived by issuer from the sale of the securities, was provided for as follows: $4,000, Construction of camps; $24,070, Diamond drilling; $25,500, Exploration power plant; $10,500, Mine office and salaries of certain employees; $50,000, Exploration in the way of shaft sinking and drifting and cross-cutting; $125,000, Equipment for a 200-ton mill; $10,000, Construction of a mill building; $18,000, Freight charges; $25,000, Transformer station; $75,000, Power line; $22,000, Miscellaneous; $102,000, Work in connection with the preparation of mine for production; $155,000, Additional power equipment and camp accommodation.

[45] *Supra* note 17.

[46] *Supra* note 43.

[47] *Supra* note 5.

[48] 1 S. E. C. 330 (1936).

capital set-up, the kind of stock to be issued, including information on par or stated value, and price per share, and, for each class of stock, the voting rights, preferences, conversion, exchange rights, liquidation rights, and similar incidents, comprise the stock data. For bonds, the present debt structure, and as to bonds to be issued, the principal amount and offering price, and the provisions for additional issuance, type of amortization provision, the security for the debt, and priorities, and provisions for substitution including a statement if substitution is permissible without notice. For Form A-2, the information required on the incidents of the securities outstanding and to be issued is much more comprehensive. Thus, in the case of bonds, not only the data required in A-1, but more specific description of the security for the debt and priorities, conditions affecting the obligation to pay interest, percentage of security holders required to move the trustee to action, provisions for modification, and inter-relationships of trustees, directors and officers, all help to complete the picture. In both forms, the balance sheet and income statement, with supporting schedules, are essential elements in furnishing the information on capitalization that the investor needs.

The balance sheet is the point at which misrepresentations and omissions of various types are, in many instances, reflected. An examination of the information given in response to the various items in the registration statement against the background of the information in the financial statements and schedules frequently reveals deficiencies either in the narrative information or the financial statements. Thus the narrative description of payments to promoters and the consideration therefor may disclose either the misapplication of accounting principles in reflecting such transactions on the balance sheet or a direct misstatement of what has occurred in the transaction as a matter of fact. For instance, the registration statement proper calls for information concerning payments to promoters and the nature of the consideration received by the issuer in return therefor. The information in the statement may show that a variety of things was given the corporation by the promoter in exchange either for money or a block of stock, such as promotional services and property transfers. The whole transaction will, in many instances, be reflected on the balance sheet as an exchange for property exclusively. In those cases the Commission insists upon a breakdown of the property item to reflect more accurately and precisely the various things received by the corporation and the amount of stock from the block attributable to each as payment therefor. This has already been viewed with respect to the promoter in the discussion of the *Snow Point Mining*[49] and other cases.

The examination technique in connection with financial statements and schedules frequently involves a blended application of principles of valuation and principles of accounting. An appraisal may give rise to a figure designated as surplus on the balance sheet. In some cases this surplus may carry no label permitting an exact identification of the origin and character thereof. If, as a matter of fact, the surplus

[49] *Supra* note 5.

is due to an appraisal of assets and is unrealized, the Commission insists upon a precise designation showing that it is of that nature. If there is reason to believe that the figure at which the assets are appraised is excessive, a detailed technical examination of the appraisal report is made, such examination being followed in a large number of cases by a physical inspection of the properties involved. Upon these bases the Commission may conclude that the figure is false, and that the surplus represented to exist is, in part or in whole, non-existent. For example, a registrant, engaged in the business of manufacturing novelty yarns from raw cotton, represented in its balance sheet that its plant, property and equipment had a value of $163,000. The cost of the plant appeared to be $63,000. A physical inspection of the properties was made, and as a result the registration statement was withdrawn.

In another registration the issuer was engaged in the manufacture of composition building materials and, in connection with its business, mined gypsum which was used as the basic ingredient in the product marketed. The gypsum deposits were carried on the balance sheet at an appraised value of $2,753,299.24 in excess of cost. The appraisal, which had been made in 1928, was based on the volume of the deposit and the rate at which the gypsum would be mined. Seven years of experience in the conduct of the business established that the rate assumed by the appraisor was far in excess of that actually attained and, in all likelihood, was seriously in error in view of registrant's future prospects. The appraised figure gave rise to an item on the balance sheet entitled "Surplus Arising from Unrealized Appreciation of Assets" in the amount of $2,753,299.24. The whole problem was further complicated by the fact that in 1932, on the authority of both directors' and stockholders' resolutions, the company wrote down the deposits by $1,086,297.95, and debited Unrealized Appreciation with a like amount, leaving a balance of $1,667,001.29 in the latter account. This balance of unrealized appreciation was wiped out by writing off the cost of selling stock previously issued, charged off in 1926 and 1927 in the amount of $206,221.06; original organization expenses charged off in 1926 in the amount of $27,861.44; market development charged off in 1928 in the amount of $75,111.11; and the following items written off in 1932: Lands and buildings, machinery and equipment, mining development cost, mine stripping cost and appreciation charged to mining costs on tonnage basis prior to 1932. The Commission raised a question in connection with these financial statements both as to the validity of the amount carried as value of the gypsum deposits and the propriety of charging off against the resulting surplus all but one[50] of the items listed above. The Commission took the position that it was improper and contrary to accepted accounting practice to combine unrealized appreciation with surplus directly, and likewise improper and misleading to use this account as a dumping ground for items which should be amortized against income.[51] The effect of these devices was to relieve

[50] The exception was a charge of $61,164.08, which had been made to appreciation charged to mining costs on tonnage basis prior to 1932.

[51] A steel company created a reserve for plant retirements by charges to paid-in surplus and shortly thereafter, in 1932, wrote off properties retired in the amount of $1,744,213.61, making the charge to

surplus of certain charges and to prevent the determination of the extent of the write-up remaining in the net assets. The problem was finally solved when the issuer included in an amended registration statement and prospectus two balance sheets, one as originally submitted based on the appraisal and the second based upon the cost of the physical assets, with appropriate explanations concerning the respective bases. The accountant in his certificate stated that the "cost" balance sheet reflected accepted accounting principles.

This same procedure of having two balance sheets, one representing the figures of the issuer, and the other in accord with accepted accounting principles, is found in a public utilities system registration. The balance sheet originally filed represented that this public utilities system had a capital surplus of approximately $111,000,000 and an earned surplus of approximately $12,000,000. There were pages of footnotes appended to this balance sheet which revealed on close study that improper accounting and financial practices had been followed. The Commission required the registrant to present an adjusted balance sheet reflecting these practices which would serve for comparison with the original figures. The adjusted balance sheet revealed a corporate deficit of $30,000,000, as well as a reduction of $153,000,000 in the company's assets.

A variation of Commission treatment of financial statements is illustrated in the registration of another public utilities system. The company had written up its assets on the basis of an appraisal made by an affiliate. The unrealized appreciation thus created was then charged with unamortized bond discount and expense, which should have been amortized over the life of the bonds on which it was incurred. The effect of these methods was to overstate earnings over a period of years. The Commission required that the footnotes to the balance sheet indicate what earnings would have been if proper accounting practices had been followed.

The recent case of *Mining and Development Corporation*[52] illustrates the adaptability and evolution of the administrative process. Some of the company's properties had been valued on a basis admittedly improper, and the registrant had filed an amendment eliminating this improper basis but retaining the same figure with a footnote warning that this figure did not represent present value. The Commission's holding that this figure could not stand has been discussed in connection with Promoters. But the Commission went on to deal with the argument that the footnote served to correct the untruth represented in the balance sheet:

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this reserve. The facts in the case indicated that depreciation charges in previous years had been insufficient to provide for the normal retirement of the properties. The charge to the reserve created from paid-in surplus thus relieved the earned surplus of the charge. The accountant had failed in his certificate to express an opinion on this procedure. The Commission took the position that the auditor had not complied with the requirement that he express an opinion on the accounting practices and procedures followed by the registrant. The accountant thereupon inserted the following statement in his certificate: "We are of the opinion that it would have been preferable to have made such charges against Earned Surplus, and in such event the Earned Surplus and Paid-in Surplus of the registrant would have been $..... and $..... respectively."

[52] *Supra* note 17.

"Nor is this figure saved by the accompanying disclaimer in the footnote. The footnote itself is deceptively similar to a common form in general use by conservative accountants who wish to make clear that they accept no responsibility for valuations, as lying outside their province. This footnote gives no indication that the net present value, far from being the open question which it suggests, has actually been ascertained, in accordance with proper application of the technique improperly followed, to be definitely less than the amount stated on the balance sheet. The footnote as submitted by no means adequately informs the investor and should not be permitted to protect the registrant. Moreover, even were the footnote to state with complete frankness the true fact that the assets were over-valued, this would not mitigate the effect of the valuation figure itself. A balance sheet item which is flatly untrue will not be rendered true merely by admission of untruth."

The development of the concept of full disclosure exemplified in these cases, even though substantial grounds for distinction may exist, is most significant. But there have been other developments which at least merit mention in connection with financial statements.

In the *Haddam Distillers*[53] and *Continental Distillers*[54] cases, the use of *"pro forma"* balance sheets showing cash on hand from proceeds of the securities to be issued was held misleading when the underwriters were under no firm commitment but merely had an option to take down stock. In the *Franco Mining*,[55] *Lewis-American Airways*,[56] *American Terminals & Transit*,[57] and *Mining and Development*[58] cases, the setting up of a lease-hold interest as a fee was held misleading. The failure to calculate the present value of future income in appraising mining property was held misleading in the *La Luz Mining*,[59] *American Terminals and Transit*, and *Mining and Development* cases. The failure to write off worthless experimental expenses was held misleading in the *American Gyro* case.[60] Many others might be added. Enough has been shown to demonstrate that the investor should benefit from the disclosure of such practices as these.

CONCLUSION

The object of the Act, full disclosure, can be achieved only if basically the statute requires information on matters essential to the exercise of intelligent and sound judgment and if the Commission in administering the Act discovers and applies principles and policies resulting in that disclosure in media and form within the range of understanding of the investing public.

It is quite apparent that the nature and extent of the disclosure accomplished by the administration of the Act exceeds that anticipated by early commentators on the statute. Quite obviously, perfection has not been attained, but the fluidity and adaptability of the administration of the registration provisions of the Act, giving form and content and new meaning to the information required by Schedule A, gives increasing encouragement that the Act, even though it falls short of some of its aims, is the first step towards the creation of a more enduring and substantial basis for security selling to the public.

[53] *Supra* note 8. [54] *Supra* note 3. [55] *Supra* note 6. [56] *Supra* note 48.
[57] *Supra* note 34. [58] *Supra* note 17. [59] *Supra* note 12. [60] *Supra* note 40.

In addition to these basic questions of statutory authority and administrative wisdom, there are other factors at work which should promote the attainment of the objective. There has been a gradual development of a group of experts, outside as well as inside the Commission, whose knowledge of the Act and familiarity with its requirements make for ease and clarity of presentation of material in a prospectus. At the same time, the Commission in its various rulings and releases, particularly in its findings of fact and opinions, keeps the investing public abreast of and acquainted with the various devices employed to suppress or misrepresent material facts relevant to an appraisal of the value of the securities.

The educational value of these opinions should aid in the development of the intelligent investor. But the requirements of the Act are not based solely on the belief that the investor will learn to protect himself. As in other fields, reliance is placed on the development of independent experts. The investment counsel, the investment department of a bank and the financial advisory services obtain essential information concerning securities with a relatively broad market. This information was hitherto often undisclosed even to powerful institutional and personal buyers. These experts, armed with sufficient information, serve to give the investor new protection. Investment tends to become something less than gambling and more of a process on which intelligence may be brought to bear.

Moreover, the protection of the Securities Act is not the only bulwark for the investor. It is part of a coherent development extending through many years that has endeavored to insure adequate publicity as to corporate affairs. This development is based on the belief that a business which has outgrown a personal character should assume obligations commensurate with its enlarged opportunities as a public enterprise. The listing requirements of stock exchanges, the requirements of state "blue-sky" laws, the regulations of the Interstate Commerce Commission within its jurisdiction, are all instances of this development prior to the Securities Act. The emphasis of the Securities Act is on information in connection with the issuance of a security. That continuing information about securities is desirable is evidenced by the requirements of the Securities Exchange Act of 1934, which helps complete the growing network impelling full disclosure of the facts of corporate enterprise. The significance of the Securities Act must be considered in light of this larger development.

These factors serve to implement the basic mandate of full disclosure embodied in the Act. This mandate will not serve to cure all the intricate problems involved in investment. But the emphasis on the underlying elements in the investment picture has furthered the attainment of desirable objectives. It has aided the investor not only in the prevention of past abuses but also in the clear presentation of the present factors of significance. The data obtained have laid the basis for further legislation in this field. The Act and its administration deserve credit for this threefold attainment.

THE LAWYER'S PROBLEMS IN THE REGISTRATION OF SECURITIES

ARTHUR H. DEAN*

The spirit of reform which swept Mr. Roosevelt into office in 1932 brought in its wake the Securities Act of 1933.[1] As a measure of social regulation, it was long overdue. But it imposed upon an almost completely *laissez-faire* market a strait-jacket of very rigorous regulation. The shock to such a delicate mechanism was naturally considerable. The jacket was made considerably more comfortable by amendments passed in 1934[2] and by a vigorous overhauling of the forms, on which securities were registered, by the Securities and Exchange Commission. The relative merits or demerits of the Act are now out of the realm of controversy and bitterness, and its permanence as a part of our social fabric definitely established. It has been said, in substance, that it represents the aspirations of a people who do not again wish to see their life savings put in jeopardy.[3] Yet it must be said at once that while publicity is a great weapon, the Act alone cannot prevent economic cycles from pursuing their course, invention displacing invention, or the launching of ill-advised and badly managed enterprises with consequent losses to security holders.[4]

The Act itself does not proceed on any super-governmental agency's saying whether it is wise or unwise to issue or to buy the securities. Or even upon whether the securities are good or bad. But rather on the theory that those issuers who wish to avail themselves of the privilege of selling their securities in interstate commerce or through the mails must tell the truth and the whole truth or take the consequences. The Securities and Exchange Commission can determine whether on the face of a registration statement the complete truth appears to have been told (although the

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[1] Pub. No. 22, 73d Cong., 1st Sess. (1933), 48 STAT. 74, 15 U. S. C., c. 2A, as amended by Pub. No. 291, 73d Cong., 2nd Sess. (1934), Tit. II, §§201-211, 48 STAT. 881, 15 U. S. C., c. 2B, §78a, hereinafter cited as the "Securities Act" and sometimes called "the Act."

[2] Pub. No. 291, 73d Cong., 2nd Sess. (1934), *supra* note 1.

[3] See Address of James M. Landis before Investment Bankers Ass'n of America at Augusta, Ga., on Dec. 4, 1936, reported in *N. Y. Times*, Dec. 5, 1936, p. 29.

[4] May, Memorandum regarding Securities Bill, H. R. 4314; Douglas and Bates, *The Federal Securities Act of 1933* (1933) 43 YALE L. J. 171; James, *The Securities Act of 1933* (1934) 32 MICH. L. REV. 624, 626-627; Dulles, *The Securities Act and Foreign Lending* (1933) 12 FOREIGN AFFAIRS, 33.

fact that a registration statement has become effective does not indicate that the Commission has passed on its correctness);[5] and may dictate the form in which the story is told; but, if the truth is told, however worthless the securities, the Commission may neither approve nor disapprove of them.[6]

It may serve to clarify for the reader the writer's approach to the general problem by stating in advance that he is in full sympathy with the underlying purposes of both the Securities Act of 1933 and the Securities Exchange Act of 1934 and with the administrative problems facing the Commission.[7] Even if a majority of individual investors should decide they didn't need these acts, he believes the financial community, purely from a selfish standpoint, cannot afford to be without them.

I

THE PROBLEM OF MATERIALITY

Now the task of furnishing a prospective investor, who presumably knows nothing about a company and its affairs, with all pertinent information concerning it, without misstating or omitting any material fact, is not a simple one. *First,* because we necessarily must tell the proposed investor about the past and leave him to draw inferences therefrom as to the future; *Second,* corporations and our economic society today are complex and not simple, and *Third,* to tell such prospective investor everything about a company without arrangement, correlation and synthesis may well confuse him. Arrangement, correlation and synthesis involve condensation. Condensation, in turn, involves omission. All involve emphasis. And to emphasize may be to distort.

In transmitting the draft of the original bill to the Congress on March 29, 1933, the President said "that no essentially important element attending the issue shall be concealed from the buying public."[8] Surely there can be no quarrel with this statement. The rub comes in attempting to determine in advance what is an "essentially important element." There enters the human equation. For the registrant and its counsel must attempt to determine each "essentially important element" in advance of a decline in security prices and in advance of statements being attacked as mis-

[5] Section 23 of the Act provides: "Unlawful representations.—Neither the fact that the registration statement for a security has been filed or is in effect nor the fact that a stop order is not in effect with respect thereto shall be deemed a finding by the Commission that the registration statement is true and accurate on its face or that it does not contain an untrue statement of fact or omit to state a material fact, or be held to mean that the Commission has in any way passed upon the merits of, or given approval to, such security. It shall be unlawful to make, or cause to be made, to any prospective purchaser any representation contrary to the foregoing provisions of this section."

[6] While the above statement is true with respect to the activities of the Securities and Exchange Commission under the Securities Act of 1933, compare §6 of the Public Utility Act of 1935, Pub. No. 333, 74th Cong., 1st Sess. (1935), 49 STAT. 803, 15 U. S. C., c. 2C, forbidding any registered holding company or subsidiary company thereof, with certain exceptions, to issue or sell certain types of securities except in accordance with a declaration which shall have become effective under §7 of that Act and which in effect requires the approval of the Commission.

[7] Memorandum on the Proposed Federal Securities Act, dated April 4, 1933, filed by the writer with the Senate Committee on Banking and Currency, April, 1933, Report of Dickinson Committee.

[8] H. R. REP. No. 85, 73d Cong., 1st Sess. (1933), p. 2.

leading; they must strive not only to see that no "essentially important element" is omitted but to see that the story is presented to the investor in concise and readable form. And this is not simple. Because, although a statement must be judged years later in the light of what was known at the time it was made, nevertheless, that which may have seemed relatively unimportant at the time of filing a registration statement may later prove to have been distinctly material. A mistake in judgment? Yes, but the Act says that the issuer and not the investor must take the consequences for such mistake.[9] It therefore behooves an issuer to know what is "material."[10]

In its instruction book for Form A-2, the Commission has defined "material" when used to qualify a requirement for the furnishing of information as to any subject, as limiting "the information required to such matter as to which an average prudent investor ought reasonably to be informed before purchasing the security registered." Since liability still exists in equity in rescission actions and at common law for damages caused by fraud,[11] and under various state "Blue Sky" statutes, in addition to the liability under the Securities Act of 1933,[12] it is, of course, necessary to determine in addition what will be deemed "material" at common law.

The American Law Institute, in its *Restatement of the Law of Contracts,* has attempted a definition so that materiality may be determined in advance, *i.e.,* the so-called "objective," rather than the "subjective," test. In Section 470(2) of this Restatement, it is stated:

"Where a misrepresentation would be likely to affect the conduct of a reasonable man with reference to a transaction with another person, the misrepresentation is material, except as this definition is qualified by the rules stated in §474."

[9] Securities Act, §11.

[10] Liability does not exist because of the misstatement or omission of any fact. For liability to exist, it must be a "material" fact. See Securities Act, §§11, 12(2) and 15. Obviously every fact stated cannot be "material," as otherwise the Congress would have omitted the qualifying adjective. As originally drafted, liability under §11 of the Act (see H. R. 5480, 73d Cong., 1st Sess., submitted May 3, 1933), was predicated on the omission to "state any material fact." This was later amended after long discussion as to whether or not this would require discussions of tariff laws, etc., by adding the additional language "required to be stated therein or necessary to make the statements therein not misleading." The theory on which the additional language was added was that a written statement might be false not only because of what it stated, but also because of what it concealed, or omitted, or implied, or otherwise stated, and that a selection from the whole truth so partial and fragmentary as to give a misleading impression should be ground for civil liability despite the literal truth of every statement made. See Rex v. Lord Kylsant [1932] 1 K. B. 442. See Note (1932) 45 HARV. L. REV. 1078.

[11] 3 WILLISTON, CONTRACTS (1st ed. 1920) §1490; Colton v. Stanford, 82 Cal. 351, 23 Pac. 16 (1890); Flight v. Booth, 1 Bing. N. C. 370 (1834).

[12] See, *e.g.,* ILL. REV. STAT. (Smith-Hurd, 1933) c. 121½, which classifies securities in various classes and provides for the filing of the different types of information for the various classes, dealers' permits, brokers' permits, etc. The New York "Martin Act," N. Y. GEN. BUS. LAW, N. Y. CONS. LAWS (Cahill, 1930) c. 21, art. 23A, is not of the general "Blue Sky Law" type which laws regulate the qualification and sale of securities, but rather what is known as the "Fraud Act" type of law, designed to prevent fraud in the sale of securities and in other securities dealings by giving the Attorney General of the State extensive power to issue subpoenas and to investigate transactions. Registration of securities under the New York "Martin Act" is not required, but a "Further State Notice" must be filed as to every non-exempt security.

And in Section 474:

"A manifestation that the person making has no reason to expect to be understood as more than an expression of his opinion, though made also with the intent or expectation stated in §471, is not fraud or a material misrepresentation, unless made by

(a) one who has, or purports to have expert knowledge of the matter, or

(b) one whose manifestation is an intentional misrepresentation and varies so far from the truth that no reasonable man in his position could have such an opinion."

The Restatement may not be followed in all jurisdictions, and we therefore cannot be sure that the test of "materiality" under the Act and in suits brought on prospectuses in state courts, not specifically based on the Act, will be the same.

In view of the constructive and coöperative attitude which the Securities and Exchange Commission has taken and of its constant willingness further to clarify the meaning of the Act, the questions in the forms and the instructions relating thereto, it may sound ungracious to state that the task of preparing a registration statement for an issuer is still no mean one. Nor should it be. But the mere fact that the Securities and Exchange Commission has promulgated some twelve forms and instruction books for the registration of various types of securities with the Commission under the Securities Act of 1933 and is constantly working on other forms and instruction books to meet different situations, may serve to indicate the complexity of the problem.

II

THE COMPLEXITY OF REGISTRATION STATEMENTS AND PROSPECTUSES

In this article the writer does not wish to engage in any controversial argument as to whether the liabilities imposed on an issuer of securities, its directors and officers, experts and underwriters are reasonable or unreasonable, or whether or not such liability should be modified. Nor does he wish to discuss the qualitative or quantitative measure of such liability as compared with that existing prior to the passage of the Act. Such subjects have already been covered at length.[13] Suffice it to say,

[13] Ballantine, *Amending the Federal Securities Act* (1934) 20 A. B. A. J. 85.

Bane, *The Securities Act of 1933*, PROC. NAT. ASS'N OF SECURITIES COMM'RS, 1933, p. 94.

Bane, Dean, and Richardson, Addresses before the Mining and Metallurgical Society of America, March, 1935, M. & M. SOC. BULL. No. 233, p. 23.

Berle, *New Protection for Buyers of Securities*, N. Y. *Times*, June 4, 1933, §8, p. 1; *High Finance: Master or Servant* (1933) 23 YALE REV. 20.

Brownell, *The Federal Securities Act of 1933*, BARRONS, July 10, 1933, p. 3; *How Can the Securities Act be Made Workable?* BARRONS, Nov. 6, 1933, p. 3; *Is the Securities Act Sound?* TODAY, Dec. 30, 1933, p. 6.

Chamberlain, *The Securities Act of 1933* (1933) 19 A. B. A. J. 643.

Cook, *Certainty in the Construction of the Law* (1935) 21 A. B. A. J. 19.

Dean, *The Federal Securities Act: I*, FORTUNE MAG., Aug. 1933, p. 50; *The Amended Securities Act*, FORTUNE MAG., Sept. 1934, p. 80; *Economic and Legal Aspects of the Federal Securities Act of 1933*, PROC. NAT. ASS'N OF SECURITIES COMM'RS, 1933, p. 160; *The Securities Act and The Securities Exchange Act* (address before Mass. Society of Certified Public Accountants, Boston, Mass., Oct. 22, 1934); *Securities Act of 1933—An Appraisal*, N. Y. *Herald-Tribune*, Jan. 2, 1935; *The Federal Securities Act: An Examination by a Critic*, N. Y. *Times*, Oct. 15, 1933.

however, that so long as the issuer and those in control of the issuer are, in effect, absolute guarantors of the complete accuracy of all "material" information in a registration statement and prospectus and are not allowed to reduce their liability by proving reasonable investigation and reasonable care, registration statements and prospectuses will probably continue to be unduly long and therefore unduly complex. For example, even though the issuer retains the ablest financial officers it can find, and an accounting firm of the highest reputation to examine and certify to its accounts, engineering experts to certify to its properties, and legal experts to advise it, and acts in the utmost good faith, it may, nevertheless, be liable to a purchaser in case the registration statement, as filed, contained material misstatements or omissions.[14] The accounting officers, the firm of accountants and the other experts may

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Dodd, *How Not to Amend the Federal Securities Act—The Fundamental Purpose Should Not Be Impaired* (1934) 20 A. B. A. J. 247.

Douglas and Bates, *The Federal Securities Act of 1933* (1933) 43 YALE L. J. 171; *Some Effects of the Securities Act Upon Investment Banking* (1933) 1 U. OF CHI. L. REV. 283.

Frankfurter, *The Federal Securities Act: II,* FORTUNE MAG., Aug. 1933, p. 53.

Flexner, *The Fight on the Securities Act,* ATLANTIC MONTHLY, Feb. 1934, p. 232.

Gordon, *Accountants and the Securities Act* (1933) 56 J. OF ACCOUNTANCY, 438; *Liability of Accountants Under Securities Exchange Act of 1934* (1934) 58 *id.* 251.

Hall, *Problems of Accountants Under the Securities Act of 1933* (1933) 56 J. OF ACCOUNTANCY, 452.

Hanna and Turlington, *The Securities Act of 1933* (1933) 7 So. CAL. L. REV. 18; *The Securities Act of 1933* (1933) 28 ILL. L. REV. 482.

Herlands, *Interpretation of the Federal Securities Act with particular reference to Criminal Liability, Part 1* (1933) 67 U. S. L. REV. 562; *Part 2, 67 id.* 615.

Isaacs, *The Securities Act and the Constitution* (1933) 43 YALE L. J. 218.

Kessler, *The American Securities Act and its Foreign Counterparts: A Comparative Study* (1935) 44 YALE L. J. 1133.

Landis, Address before N. Y. State Society of Certified Public Accountants, *Wall St. J.,* Nov. 1, 1933, p. 10.

Landis, Starkey, Broad, Thomas and Dean, Addresses before American Management Ass'n., Oct. 9, 1935.

MacChesney, *The Securities Act and the Promoter* (1936) 25 CALIF. L. REV. 66.

MacIntyre, *Criminal Provisions of the Securities Act and Analogies to Similar Criminal Statutes* (1933) 43 YALE L. J. 254.

Mead, *Amend the Securities Act* (1933) 1 ECON. FORUM, 425; Legis. (1933) 33 COL. L. REV. 1220.

Means, *Protecting the Buyers of Securities; A New Approach, N. Y. Times,* April 9, 1933, §8, p. 3.

Rayburn, *Is the Securities Act Sound?* TODAY, Dec. 30, 1933, p. 7.

Rodell, *Regulation of Securities by the Federal Trade Commission* (1933) 43 YALE L. J. 272.

Seligman, *Amend the Securities Act,* ATLANTIC MONTHLY, March 1934, p. 370; *An Analysis of the Securities Act Amendments, N. Y. Times,* June 6, 1934.

Shulman, *Civil Liability and the Securities Act* (1933) 43 YALE L. J. 227.

Starkey and Henderson, *Practice under the Securities Act of 1933 and the Securities Exchange Act of 1934* (1934) 58 J. OF ACCOUNTANCY, 451.

Wherry, *The New Federal Securities Act* (1933) 12 P. U. FORT. 123.

The Responsibility of Directors, THE ECONOMIST, Dec. 23, 1933, p. 1222.

Comment, *Civil Liability for Misstatements in Documents filed under Securities Act and Securities Exchange Act* (1935) 44 YALE L. J. 456.

Comment, *Liability of Directors and Officers for Misrepresentation in the Sale of Securities* (1934) 34 COL. L. REV. 1090.

Report of Special Committee of Am. Bar Ass'n on Amendments to the Securities Act of 1933, April, 1934.

Supplemental Report of Special Committee of Am. Bar Ass'n on Amendments to the Securities Act of 1933, April 15, 1935.

[14] Securities Act, §11.

escape liability by sustaining the burden of proof imposed by Section 11 of the Securities Act of 1933 with respect to reasonable investigation and reasonable grounds to believe in the truth of the matters certified. But the issuer itself is held to a rigorous and inexorable standard. Admitting, for the purpose of discussion, that the burdens placed on an issuer under the Securities Act of 1933 may, in our complex society, be socially desirable, the fact remains that the public should not be surprised to find issuers setting forth in their registration statements all sorts of apparently irrelevant facts, in the greatest of detail, in an endeavor not only to avoid ultimate liability but to avoid such liability being asserted. It is not pleasant to be accused, even though the suit is later won, of having sold securities on the basis of misleading information. And since no one can assure an issuer that reasonable investigation and reasonable care will save it from liability, or can assure it in advance that data suggested for insertion in a statement definitely is not "material," it is hard to blame the issuer and its officers for inserting what seems like irrelevant data if they honestly believe it to be "material." Many counsel argue that the mere fact that reasonably-minded men can argue as to whether something is or is not "material" is a fairly good reason for its inclusion. To be sure, the Commission has, in its instruction book to Form A-2, sub-division 6, under "General Rules as to the Form," stated:

"Where 'brief' answers are required, brevity is essential. It is not intended, in such case, that a statement shall be made as to all the provisions of any document, but only, in succinct and condensed form as to the most important thereof."

This is distinctly helpful but it is also obvious that the issuer and its counsel must decide as to which are "the most important thereof" and must satisfy themselves that the statements in "succinct and condensed form" or in "condensed or summarized form" do not (so far as the registration statement is concerned)

"contain an untrue statement of a material fact or omit to state a material fact required to be stated in the registration statement or necessary to make the statements therein not misleading"[15]

and do not (so far as the prospectus is concerned)

"include an untrue statement of a material fact or omit to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading."[16]

In Rules 821 through 838 and in the instruction book for Form A-2, entitled "Instructions as to the Prospectus," the Commission has stated:

"The information set forth in a prospectus, except as to financial statements, may be expressed in condensed or summarized form."

Persons who are inclined to be critical of an issuer or its counsel for not following the admonitions of the Commission exactly should remember that each prospectus

[15] *Ibid.* [16] *Id.* §12(2).

must also contain (presumably pursuant to Section 23 of the Act) the following statements:

"These securities have not been approved or disapproved by the Securities and Exchange Commission. The Commission has not passed on the merits of any securities registered with it. . . .

"It is a criminal offense to represent that the Commission has approved these securities or has made any finding that the statements in this prospectus or in the registration statement are correct."[17]

To avoid liability with respect to an allegedly deficient prospectus under Section 12(2) of the Securities Act, the seller must prove (if the purchaser has proved he did not know of the untruth or omission complained of) either that the prospectus did not include an untrue statement of a material fact, or that it did not omit to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading. Or else that "he (the seller) did not know, and in the exercise of reasonable care could not have known, of such untruth or omission." Since the prospectus is a digest of the registration statement, the status of a registrant, who is found to have condensed unduly in a prospectus data to be found in the registration statement, may be anything but a happy one when he endeavors to prove he "could not have known, of such untruth or omission." He must have known the full facts, since they are in the registration statement. He must accept the responsibility for determining, as a matter of law, that there has been no *undue* condensation.

Harold H. Neff, Director of the Division of Forms and Regulations, has said:

". . . The prospectus is meant to be an epitome or summary, and, obviously, cannot be as discursive as the longer registration statement. The rule clearly indicates that the prospectus is not to contain the same degree of particularity as the registration statement.

"It is patent, therefore, that condensation or summarization involves omission; for it is not to be assumed that surplusage is contained in the registration statement itself. Indeed, in most places in the registration statement, answers are required to be stated briefly. A summarization or condensation of matter which has already been stated briefly must, of necessity, involve a greater brevity and an increased terseness, which can be attained only by a reduction in word content. To repeat, this reduction can be achieved only by the omission of material."[18]

This is, of course, helpful but with the possibility of facing a vigorous cross-examination of why this, that and the other item was omitted or perhaps unduly condensed from a registration statement in questionnaire form, the issuer may be pardoned for not taking full advantage of this excellent but nevertheless only permissive advice. The registrant can always play safe by summarizing at length rather than briefly. He is not compelled to condense and hence cannot plead compulsion.

[17] See subdivision 3 under "Instructions as to the Prospectus" in Instruction Book—Form A-2, Securities Act Release No. 598, Dec. 10, 1935; S. E. C. GEN. RULES AND REGULATIONS, Rule 825.

[18] Securities Act Release No. 874, July 2, 1936.

He summarizes entirely at his own risk. Hence, there is no surety that if the advice quoted above is followed, it may not result in liability.

At the risk of being tiresome, it must be repeated that in case a suit is brought alleging that a registration statement on its effective date

"contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading"

the issuer has two defenses, and only two, *i.e.:*

1. That at the time of the acquisition of the security, the person suing knew of such untruth or mission, or

2. That any portion or all of the damages claimed represents depreciation in value of the security in question from some other cause than the one alleged in the complaint, *i.e.,* that a particular part of the registration statement on its effective date was not true or else that it omitted to state a material fact required to be stated therein, or necessary to make the statements therein not misleading.

According to the Rules of the Commission,[19] although the Act does not require it, a prospectus must be filed as an exhibit to the registration statement, so that apparently an issuer may be sued under Section 11 as well as under Section 12(2) for errors or omissions in the prospectus.

The foregoing is all rather academic, of course. What are these great problems with which the issuer and his counsel are concerned? Why do they not assume their social responsibilities, tell the truth in a straightforward manner and be done with all this arguing?

III

STEPS IN THE PREPARATION OF REGISTRATION STATEMENTS AND PROSPECTUSES

It is difficult to discuss the problems an issuer faces in preparing a registration statement apart from a consideration of some of the work which has to be done in preparing and passing upon a securities issue. Most of the work listed below, with the exception of the preparation of the registration statement and of the prospectus in the form prescribed by the Commission, had to be done prior to the passage of the Securities Act of 1933. All of the work enumerated below may not, for one reason or another, have to be done on a particular issue. Each issue presents difficult and unique problems, and the writer does not intend to indicate that neglect or failure to investigate any one or more of the following items would be a failure to use due care. The mere statement of some of the problems may sound trivial. It is the multiplication of problems, however trivial, that causes difficulty, and many of these problems, however unimportant they may sound, frequently take many hours and days of hard work to solve. In order to discuss the problem in its true perspective, let us therefore enumerate some of the questions which must be considered, studied and decided.

[19] Form A-2 contains the following: "This registration statement comprises: . . . (4) The prospectus, consisting of. . . . pages."

Let us assume we are preparing a registration statement for a public utility corporation which proposes to issue $10,000,000 of bonds to refund an outstanding issue. In order to simplify the discussion, let us assume it can file its statement on Form A-2,[20] although the task of deciding which form to use frequently involves a detailed investigation and checking with the Commission. Reference will therefore be made to Form A-2, the simplest of all of the forms promulgated by the Commission for the registration of securities under the Securities Act of 1933. If it were necessary to use Form A-1, the work would be magnified many times. Since the outstanding bonds are, let us assume, only callable on an interest date on thirty days' notice, we obviously must start the work of preparing the registration statement and prospectus in time to permit the following:

1. *Assignment to Various Individuals of the Task of Assembling Information.*

(a) The assignment to various officers of the issuer and of its subsidiaries of the task of getting up the necessary data for the registration statement, with instructions to submit the proposed answers, with the supporting data, by a definite date. This date must be sufficiently in advance of the proposed filing date to allow time for checking the data, recasting it in proper form and correlating it with the whole. This involves a careful study of the various questions in the form and explaining

[20] Instruction Book for Form A-2 for Corporations provides in part as follows:
"Rule as to the Use of Form A-2 for Corporations.

This form is to be used for registration statements, except such statements as to which a special form is specifically prescribed, under the Securities Act of 1933, as amended, by any corporation which files profit and loss statements for three years and which meets either one of the following conditions: (a) such corporation has made annually available to its security holders, for at least ten years, financial reports (which may be reports consolidating the reports of the corporation and its subsidiaries) including at least a balance sheet and a profit and loss or income statement, or (b) such corporation had a net income for any two fiscal years of the five fiscal years preceding the date of the latest balance sheet filed with the registration statement. If such corporation has subsidiaries, such income shall be determined on the basis of consolidated reports for such corporation and its subsidiaries. Notwithstanding what is hereinabove prescribed in this paragraph, however, this form shall not be used by any corporation organized within ten years, if the majority of the capital stock thereof was issued to promoters of the corporation in consideration of property or services, or if more than one-half of the proceeds of the sale of securities of such corporation has been used to purchase property acquired by the corporation from the promoters of the corporation.

"(Note: If, under the foregoing Rule as to the Use of Form A-2 for Corporations, the applicability of this form to any corporation depends upon net income, for two fiscal years, and if either or both of such two fiscal years antecede the period for which profit and loss statements are required by the Instructions as to Financial Statements in this Instruction Book, such corporation shall furnish for the information of the Commission at the time the registration statement is filed, but not as a part of the registration statements, profit and loss statements, in addition to those required by the Instructions as to Financial Statements, for the earlier of such antecedent fiscal years and for any intervening period prior to the first year for which such statements are required by the Instructions. Such additional profit and loss statements shall be prepared in accordance with the Instructions as to Financial Statements, except that they need not be certified and no schedules need be furnished.)

"The form is to be used for all statements, falling within the conditions prescribed, filed on or after January 15, 1935, except that Form A-1 may be used for statements for which the rules otherwise permit or prescribe Form A-1, if such statements are filed on or before March 15, 1935."

In addition to the foregoing, there are special rules as to the use of Form A-2 for Corporations, instead of Form E-1, the form normally used in connection with the exchange of securities where the issuer is otherwise entitled to use Form A-2. The Instructions with respect to the use of the Form and the Instructions with respect to the balance sheet must be carefully followed.

what is wanted, supervising the preparation of appropriate questionnaires, agreeing on the officers to collect the data and arranging for a clearing agency.

(b) Assigning the task of investigating the history of the company and its subsidiaries, the general development of the business and of any important changes therein, to officers of the company and to engineering experts.

(c) Assigning the task of investigating the various types of business done, rate schedules, improvements of various types and development or decrease of various types of business done. This should include ascertaining whether materially important plants have been acquired, sold or abandoned; whether materially important changes have been made in the mode of conducting the business; whether there has been a change from steam to hydro or hydro to steam; whether there has been a pronounced drought or pronounced rainfall during the last past several years and if so what the general effect has been upon operating expenses or economies.

2. *Arrangements for the Examination of the Issuer's Accounts.*

(a) Giving of instructions to the accountants to make an examination of the issuer's accounts down through a date as near as practicable to the proposed filing date,[21]

[21] Ordinarily, according to "Instructions as to Financial Statements" of the Instruction Book for Form A-2, there must be filed at the time of the filing of the registration statement a balance sheet of the issuer and a consolidated balance sheet of the issuer and its subsidiaries, prepared in accordance with the Rules of Consolidation set forth therein, both as of a date within ninety days. If such balance sheets are not certified, there must be submitted, in addition, certified balance sheets as of a date within one year; provided that if the fiscal year of the issuer has ended within ninety days of the date of filing, the certified balance sheets may be as of the end of the preceding fiscal year. There must also be submitted profit and loss statements of the issuer and consolidated profit and loss statements of the issuer and its subsidiaries prepared in accordance with the Rules of Consolidation therein set forth, in each case year by year, for the three years preceding the date of the latest balance sheet filed, and for the period, if any, between the close of the latest of such fiscal years and the date of such latest balance sheet. Such profit and loss statements must be certified up to the date of the last certified balance sheet.

In certain instances the balance sheets required need be only as of a date within six months of the date of filing the registration statement, and the balance sheets of unconsolidated subsidiaries need be only as of the latest fiscal year of the respective consolidated subsidiaries if all of the following conditions are met:

1. No funded debt of the issuer is in default as to principal, interest or sinking fund provisions;

2. The total assets of the issuer, as shown by the latest balance sheet of the issuer filed with the registration statement, amount to $5,000,000 or more; and

3. The issuer has at least one class of its securities registered on a national securities exchange.

In addition, there are various other exceptions and there are special requirements as to financial statements in case a consolidation shall have occurred within ninety days prior to the date of filing. See Instruction Book for Form A-2, Special Rule 5B. Certified balance sheets and financial statements must be filed for subsidiaries which are not consolidated if the issuer's investment in such subsidiaries is significant in respect of either the assets represented or the sales or operating revenues of the subsidiary. While the Rules of the Commission in this respect are distinctly helpful to an issuer (although some leeway in certain instances of a few days would save much trouble and expense) the underwriters are frequently concerned by a real problem. In order to avoid liability under Section 11, they must prove, in the event of suit, that they had reasonable ground to believe that the statements in the registration statement were true and not misleading on the effective date of the registration statement. With respect to those portions of the registration statement not purporting to be made on the authority of an expert, an underwriter, director or officer of the issuer, if sued, must prove, to avoid liability, that he had, after reasonable investigation "reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." As regards any part of the registration statement purporting to be made on the authority of an expert, however, an underwriter,

and going over the forms and instructions as to financial statements with the officers of the issuer and accountants. Explaining to accountants that we shall also wish them to make the necessary investigation so they may certify as experts to the answer to question 45, and item 45A of Special Rule 3 and item 45B of Special Rule 5,[22]

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director or officer need only prove that "he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." Since it is absolutely impossible for an underwriter, director or officer to make any examination of accounts which would be any protection to him, it is generally considered the better part of valor to have the accountants bring their examination of the financial statements down to as late a date as is practicable before the filing of the registration statement.

[22] Question 45 and Item 45A of Special Rule 3 and Item 45B of Special Rule 5B 3(d) as to use of Form A-2 read as follows:

"45. Furnish the information required below as to the prospective captions on the registrant's balance sheet, the balance sheet of the registrant and its subsidiaries consolidated, and each individual or group balance sheet required to be furnished for unconsolidated subsidiaries:

(a) If, since January 1, 1922, there have been any increases or decreases in Investments, in Property, Plant and Equipment, or in Intangible Assets, resulting from substantially revaluing such assets, state:
  (i) In what year or years such revaluations were made.
  (ii) The amounts of such write-ups or write-downs, and the accounts affected, including the contra entry or entries.
  (iii) If in connection with such revaluations any adjustments were made in related reserve accounts, state the accounts and amounts with explanations.

(b) If, since January 1, 1922, there have been restatements of Capital Stock, state the amounts of such restatements, and the contra entries. If, since January 1, 1922, there has been an original issue of Capital Stock any part of the proceeds of which was credited to surplus, state such amount.

(c) If, since January 1922, any substantial amount or amounts of Bond Discount and Expenses, on issues still outstanding, have been written off earlier than as required under any periodic amortization plan, give the following information: (a) title of issue; (b) date of such write-off; (c) amount written off; (d) to what account charged."

Special Rule 3 as to the use of Form A-2 for Corporations provides in part as follows:

"Any corporation filing on Form A-2 by virtue of this Special Rule 3 shall set forth in its registration statement the following additional item, designated as Item 45A, and shall furnish the information required thereby:

Item 45A. As to each business acquired by the registrant directly or through the acquisition of securities in circumstances which would have prevented the use of Form A-2 except for the operation of Special Rule 3 as to the use of Form A-2:

(a) Describe briefly the transaction by which such business or such securities were acquired, including a statement as to any write-up or write-down in Investments, in Property, Plant and Equipment, or in Intangible Assets, effected in connection with or in the course of the transaction.

(b) If the business or the securities representative thereof were acquired by the promoter looking to their transfer to the registrant, or within six months prior to their transfer to the registrant, state the cost of such business or securities to the promoter and the total amount of securities and other consideration given to the promoter therefor."

Special Rule 5B 3(d) as to the use of Form A-2 for Corporations provides in part as follows:

"5. Any corporation which was formed by the consolidation of two or more corporations may use Form A-2, if each of the constituent corporations which collectively brought in a majority of the assets, as shown by the books of the constituent corporations prior to the consolidation, could have used Form A-2 if the consolidation had not taken place.' In determining whether any such constituent corporation could have used Form A-2, the record of the registrant in regard to income or annual reporting to security holders shall be considered a continuation of such constituent corporation's record. In this rule, all the corporations consolidated to form the registrant are called the 'constituent corporations'.

"Any corporation using Form A-2 by virtue of this Special Rule 5 shall comply with the requirements set forth below: . . .

"B. Requirements as to Financial Statements. The requirements set forth below shall be in complete substitution for the provisions of part 1 of the Instructions as to Financial Statements in Form A-2, captioned 'Financial Statements of the Registrant and its Subsidiaries', except as otherwise specifically

an investigation which means going back to at least January 1, 1922. Checking whether answers will also require explanation on balance sheet and income account, such as, for example, explaining the effect on earned surplus and net income if unamortized bond discount has been charged off to capital surplus prior to the normal period for its amortization. Making sure the accountants will be able to certify the accounts down through the dates prescribed by the Commission. If for any reason the other work is delayed, and, if therefore the statement cannot be filed on the date contemplated, the accountants may have to bring the financial statements down to a still later date. This is expensive, as it means reprinting all the financial schedules and statements and may seriously delay the issue. A delay of one or two days in filing may mean weeks of extra work. While the rules of the Commission, under certain circumstances, permit the financial statements to be as of a date not more than six months prior to the date of filing,[23] if financial statements as of a later date are also included the underwriters have the problem of proving they had reasonable ground, as of the effective date of the statement, to believe such statements were true and correct.

(b) Checking with corporate officers and accountants to see if there are any unusual features in the accounts, such as past write-ups or write-downs of property; mergers or consolidations; acquisition of the assets of going companies; reduction of capital; retirement of securities; or payment of dividends out of current income when capital was impaired. If the registrant is a new corporation, formed as a result of a merger or consolidation as of a recent date, checking to see whether the accountants can prepare the financial statements called for by Special Rule 5B[24] of the Instruction Book for Form A-2, and checking with the accountants to see whether earned surplus of the constituent companies may be carried forward and if not what the effect on the surplus accounts will be. Checking with accountants and tax experts as to whether unamortized bond discount of constituent companies may be carried forward; and what the effect will be, if any, on the capital stock tax declarations of the constituent companies, filed pursuant to the Revenue Act of 1936, by reason of increases or decreases in adjusted declared values.

(c) Checking with the accountants as to the reason for and the basis of such write-ups or write-downs; what basis the assets are carried on the books; whether dividends in the past have been declared on a corporate or on a consolidated basis

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provided in paragraph 3 below. All other instructions as to financial statements in Form A-2 shall be applicable. . . .

"(d) If no financial statements for constituent corporations are filed pursuant to paragraph 3(b) above, there shall be set forth in the registration statement the following additional item, designated Item 45B, and the information required thereby shall be furnished:

"45B. Briefly describe any increases or decreases in Investments, or Property, Plant and Equipment, or Intangible Assets, or any restatements of Capital Stock or the writing off of Bond Discount and Expense, which were effected in connection with or in the course of the consolidation by which the registrant was formed, and the related entries affecting other balance sheet accounts, together with a brief explanation thereof."

[23] See note 21, *supra*.

[24] See note 22, *supra*.

and whether on the basis of depreciated or undepreciated assets;[25] and, if on the latter basis, whether such dividends may have been paid from capital.

(d) Ascertaining from the accountants the basis used in determining maintenance, depreciation, retirements and depletion and numerous other questions which are ones of mixed law, accounting and fact.

(e) Examining the minute books of the issuer and its subsidiaries and consulting with the accountants to see whether charges which should have been made to earned surplus have been made to capital surplus and whether an accumulated earned surplus deficit has been charged off to capital surplus; and if so whether the approval of stockholders was obtained at a special meeting pursuant to the recommendations embodied in the exchange of correspondence between the American Institute of Accountants and the Committee on Stock List of the New York Stock Exchange;[26] and ascertaining whether, in general, the theories therein set forth have been followed.

3. *Arrangements for Obtaining Opinions of Local Counsel on Points of Law Relating to the Issuer's Capital Structure, Title to Property, Franchises, and to the Status of the Proposed Issue.*

(a) Checking with local counsel to see if the law of incorporation has been followed in all respects: on organization; in connection with the issuance of securities; on any capital reductions or increases and on the retirement of securities; checking statutes and court decisions in state of incorporation as to what constitutes surplus, income, full-paid and non-assessable shares, etc.; checking local decisions as to what assets, such as, for example, good will, intangibles, patent rights, unamortized bond discount, deferred assets, etc., may be included in assets for the purpose of determining surplus; and whether the decisions or law of incorporation distinguish between earned surplus and capital surplus.

(b) Arranging with local counsel to have a title search of all important units of property brought down to the date of (i) the filing of the registration statement, (ii) to a period just prior to effective date of the registration statement, and (iii) to the date of delivery of the securities; checking with local counsel as to what such a title search ordinarily covers in each jurisdiction where the property is located; ascertaining the nature and extent of the search made and whether it must be expanded to include all that such searches ordinarily and customarily cover; ascertaining whether it will actually be made by counsel of good standing or whether they will rely on abstracters; checking extent of abstracters' investigation; if it is made by local title company, checking its record, ascertaining the amount of its capital and surplus and the amount of its outstanding guarantees, etc.; checking whether such a search covers personal property, motor vehicles, etc., and whether it reveals judgment liens,

[25] Guaranty Trust Co. v. Grand Rapids, G. H. & M. Ry. Co., 7 F. Supp. 511 (W. D. Mich. 1931).

[26] See Extracts from Correspondence between the Special Committee on Coöperation with Stock Exchanges, G. O. May, Chairman of the American Institute of Accountants, and the Committee on Stock List of the New York Stock Exchange (1932-1934).

tax liens, federal income tax liens, franchise tax liens, mechanics' liens, conditional sales contracts, chattel mortgages, etc.; whether an after-acquired property clause in an indenture is valid in all states whether the property to be mortgaged is located or whether intervening liens outrank it; how liens on real and personal property may be created in such jurisdictions and whether a mortgage on a shifting stock of goods is valid;[27] ascertaining the necessity for filing and refiling of the indenture, who can act as trustee and whether an individual co-trustee is necessary; method of foreclosure; whether trustee can enter and operate; right to appointment of receiver; right to deficiency judgment; validity of release provisions, of waiver of equity of redemption, of clause as to marshaling of assets, etc.; arranging for metes and bounds description of properties to be included in indenture and obtaining local counsel's approval to statements in registration statement and prospectus with respect to the lien of the indenture and of the security for the bonds.

(c) Arranging with local counsel to check granting and validity of all important franchises; indeterminate permits; rights to use public lands, forest lands, agricultural lands; right of any public body to acquire property by eminent domain; right to cancel franchises, permits, etc.; rights of public bodies to purchase property; basis of determining purchase price, etc.; whether any property escheats to public authority granting permit and if so under what conditions; if original grant of franchise, etc., required its publication, obtaining affidavits as to the manner in which publication was made, checking with statute, clearing defects, etc.

(d) Arranging with local counsel to render such opinions as are called for by the laws of various states in connection with whether securities to be issued are legal investments for savings banks, fiduciaries, etc.; checking with treasurer of issuer and accountants as to revenues derived from territory for which franchise was granted and checking basis of such calculation. Such calculations are usually most involved because of conflicting grants, overlapping territory, forfeitures, the consolidation of rural areas into cities, etc.[28]

4. *Arrangements for Obtaining Engineers' Reports.*

(a) Arranging for an independent or a company engineer's report tying both the individual and the aggregate book value of all important units of property to the property and plant figures on the balance sheet; obtaining a certificate that all buildings and structures included in property and plant account are actually located on the property described by metes and bounds in the indenture; ascertaining any exceptions and the importance thereof and whether such exceptions are sufficiently material to be mentioned in the registration statement and prospectus; checking with the engineers whether any property included in property and plant account is no longer used and useful and, if so, the extent and value thereof and what footnotes, if any,

[27] Benedict v. Ratner, 268 U. S. 353 (1925); Hammond v. Carthage Sulphite Pulp & Paper Co., 8 F. (2d) 35, (C. C. A. 2d, 1925); Brown v. Leo, 12 F. (2d) 350 (C. C. A. 2d, 1926). See, however, decision of Judge Inch in Matter of Bush Terminal Company (E. D. N. Y., Dec. 16, 1936).

[28] See N. Y. BANKING LAW, N. Y. CONS. LAWS (Cahill, 1930) c. 3, §239.

should be put in the balance sheet and the income account; ascertaining if provision is being made for its amortization and, if necessary, explaining the basis.

(b) Determining whether underwriters will wish to have an independent engineer make an examination of the property; if so, whether he is to certify to the answers to certain questions and consent to a statement that they are made upon his authority as an expert in order to give the directors, officers and underwriters the additional protection afforded by Section 11 of the Act; consulting with the examining division of the Securities and Exchange Commission as to whether they will recommend the "acceleration"[29] of any amendments if portions of the registration statement are made on the authority of an expert or to what extent they will permit statements to be "certified" by an expert;[30] clearing the language in the statement,

[29] In the case of a non-governmental issuer, if a registration statement is filed and if no amendments are thereafter filed and if it does not appear to the Commission that such registration statement is on its face incomplete or inaccurate in any material respect, it would become effective on the twentieth day after the filing thereof. Normally, however, the public offering price, the "spread" to the bankers (namely, the difference between the public offering price and the price at which the bankers purchased the issue), the redemption price of the bonds and certain other data are customarily filed in an amendment shortly before the normal effective date. Unless such an amendment is filed with the consent of the Commission prior to the normal effective date of the registration statement, the filing of an amendment starts the running of a new twenty-day period. Unless material data is filed too late for the registration division of the Commission to make an adequate examination or unless it deems no public interest will be served, the Commission usually consents to an issuer's request that amendments filed prior to the normal effective date shall be deemed to have been filed as of the same date the registration statement was originally filed. In such cases the registration statement becomes effective the twentieth day after its filing and the consent to the filing of such amendments is colloquially known as "accelerating" the amendments. Inasmuch as underwriters do not like to carry commitments for any longer period than is necessary and since the time factor is of tremendous importance in the success of an issue, it is essential that amendments be cleared with the Commission as rapidly as possible and their consent obtained to the filing thereof. Otherwise the filing of each amendment (and delay usually causes changes in the public offering price) would start a new twenty-day period running so that, unless the consent of the Commission be obtained, the statement would never become effective.

[30] Although §11 of the Act distinguishes between statements not purporting to be made upon the authority of an expert (with respect to which officers, directors and underwriters in order to avoid liability for alleged misstatements or omissions must prove, first, reasonable investigation and, second, reasonable ground to believe that the statements complained of were true and not misleading) and statements purporting to be made upon the authority of an expert (with respect to which officers, directors and underwriters need prove only that they had no reasonable ground to believe and did not believe that the statements made on the authority of such expert were untrue, or misleading), the Commission recently has been attempting to limit the extent of statements which can be made in a registration statement upon the authority of a "person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement." Due to the peculiar wording of §11, an accountant, engineer or appraiser or other expert who "prepared" or "certified" any part of the registration statement which is subsequently proved to be materially inaccurate may apparently be held liable, but the officers, directors or underwriters apparently do not get the benefit of being able to rely upon such person as an expert, according to the Commission, unless the registration statement specifically states that such portion of the registration statement is made on the authority of such person as an expert. The Commission is apparently proceeding upon the theory that those named in §11 as being liable for misstatements or omissions can have either one defense or the other but cannot have both. They have therefore been attempting to limit the field in which experts can make statements purporting to be made on their authority so as not to give those named in §11 the benefit of this additional defence despite the fact that if such statements are only "prepared" or "certified," the person making or certifying such statements may be held liable. In practice it is exceedingly difficult carefully to distinguish between mixed questions of law and facts or between questions of facts and opinions based on such facts. Inasmuch as it is impossible for some underwriters or directors to make a physical examination of the properties, this becomes particularly important in the case of statements made by engineers or in the case

and ascertaining if the examining division of the Commission will object if references to the expert's report are made in the prospectus; holding conferences as to the scope of the engineering investigation; how long it will take; whether the engineer will report on original cost or present day values, or both; and, if the latter, whether on a basis of reproduction cost new only or on a basis of reproduction cost new less accrued depreciation; whether the engineers are to report on the adequacy of maintenance and depreciation and, if so, whether it is or should be on a straight line, sinking fund, retirement method or a combined maintenance-depreciation method; whether, if past appropriations for depreciation have been too small, the surplus account is overstated and whether past earnings statements have been correct; whether the engineers will report on the general efficiency of the plant and management; its adequacy for present needs; the issuer's future capital requirements; the stability of the demand for issuer's product; the operating costs of issuer in relation to operating costs in the industry; any general advantages or disadvantages of the issuer over its competitors; the correctness of the answers to Items 5, 6 and 7[31] of Form A-2, etc. In practice, the Examining Division of the Commission also usually requires that the engineers making the report come to Washington, submit their working papers and undergo a rather rigorous examination as to the extent of the investigation which they have made and as to the reasonableness of the investigation which they have made in order to be able to certify the parts in the registration statement attributed to them.

5. *Preparation of Mortgage Indenture and Corporate Documents for Proposed Issue.*

(a) Arranging for the drafting of the terms and provisions of the securities to be offered and of the appropriate instruments under which they are to be offered, including, in particular, the indenture.

(b) The drafting of the indenture is a long, arduous and difficult task, particularly if the indenture is a so-called "open-end" one permitting the issuance of additional bonds against property additions. Among other things it will be necessary to define "property additions"; to describe in detail the terms and provisions which must be met in order for additional property to be bonded and for property no longer needed in the operation of the property to be released from the lien of the indenture; the terms and provisions on which the proceeds of released property may be withdrawn against property additions; the definition of the sources of earnings which can be included in determining, in connection with future applications for the issuance of additional bonds, whether the company has met the earnings test set forth in

of public officials with respect to foreign governmental issues. This whole question is being studied by the Commission and at the date of writing this article it is difficult to state precisely what rules govern in this connection.

[31] Items 5, 6 and 7 refer to the general character of the business done and intended to be done by the registrant and its subsidiaries; the general development of the business for the preceding five years; and the general character and location of the principal plants and other important units of the registrant and its subsidiaries, and the manner in which any important units, not held in fee, are held.

the indenture; the drafting of covenants with respect to maintenance, depreciation and insurance; the terms and provisions on which bonds may be redeemed or retired for sinking fund; defining "events of default" and setting forth the manner in which the indenture may be enforced; setting forth the manner in which various terms of the bonds and the indenture may be amended by bondholders at bondholders' meetings; the provisions with respect to the trustee; the manner in which the indenture may be satisfied, and various other provisions.

(c) Preparing a summarization of the terms and provisions of the indenture for Item 15 of the registration statement and for the prospectus.

(d) Examining the ability of the issuer to carry out the proposed program under the law of its incorporation and of states where it is doing business and under existing contracts and indentures, including, if necessary, indentures of parent companies.

(e) Arranging to obtain consents of stockholders and of public authorities required, and attending to drafting of all notices, proxies, minutes, resolutions, documents, papers, notices of redemption, etc., necessary to validate the action proposed and clearing all such documents in advance of the time for their use with the underwriters and their counsel.

(f) Fitting the time schedule for all such action into the time schedule for preparing, filing and clearing the registration statement, the offering and delivery of and the payment for the securities, and publishing the notice of redemption of the outstanding bonds.

(g) Arranging for the summarization of all documents, indentures and contracts called for by Items 14 (funded debt, other than that to be offered), 16 (stock, other than that to be offered), 17 stock, to be offered), 40 (material pending litigation), and 41 (material contracts), and for the checking thereof as to their accuracy and completeness.

(h) Arranging for the investigation by the underwriters and their counsel of all pertinent data and checking the preparation of all answers and documents with them.

6. Investigation of Legal and Beneficial Interests in Issuer of Officers, Directors and Underwriters.

(a) Sending out questionnaires to officers, directors, stockholders and proposed underwriters as to their holdings of record and beneficially of securities of the issuer and of their interest in any property sold to the issuer or of their interest in any property to be acquired with the proceeds of the issue, and checking and reconciling the replies with the corporate records of the issuer in order to answer Items 29(b), 33, 34, 35 and 38 of Form A-2.[32] The preparation of the answers to these items

[32] Items 29(b), 33, 34, 35 and 38 of Form A-2, read as follows:

"29(b). The names and addresses of the persons from whom acquired or to be acquired, specifying their relationship to the registrant, if any."

"33. Give the information required below for all persons owning of record or beneficially more than ten per cent of any class of voting stock of the registrant:

frequently presents very difficult and confusing problems to an issuer and its counsel. Thus, if an underwriter replies that it has no beneficial interest in any stock of the issuer but the issuer's records show that the underwriter is a record owner of certain of the issuer's stock, then reply and records must be reconciled. How far should the issuer go in obtaining replies from individual members of a partnership in addition to a reply from the partnership itself?[33] How far must an issuer investigate what the situation is with respect to officers, directors, stockholders and underwriters who are also executors of wills, trustees of estates or guardians of the property of infants or who are generally believed to be interested in other companies, when there are shares of the issuer owned by such estates, trusts, other companies, etc. The problem may be further complicated by the fact that directors, officers, stockholders and individual partners in banking firms which are underwriters may be named as legatees in such wills or may be life tenants or remaindermen under the trusts or may have stock of the issuer pledged with them as collateral for a loan or may be,

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"As of .....

Owner of record Name and address	Beneficial owner (if known) Name and address	Title of issue	Amount owned	Per cent of the class"

"34. The following information as to the registrant's securities owned of record or beneficially by each director and officer of the registrant, each underwriter named in answer to Item 22, and each security holder named in answer to Item 33.

NAME	POSITION	Securities owned as of		Securities owned as of ..... (Approximately one year previous)	
		Title of issue	Amount	Title of issue	Amount"

"35. Full particulars as to the nature and extent of any substantial interest of every director, principal executive officer, underwriter named in answer to Item 22, affiliate, and of every security holder named in answer to Item 33, in any property acquired within two years, or proposed to be acquired, not in the ordinary course of business. Include the cost of any such property to any such person."

Note that the cost "to any such person" must be given even though such property were acquired over a period of years and may have been acquired many years ago.

"38. For all securities of the registrant sold by the registrant to any persons other than employees within two years, furnish the following information:

"(a) Title of issue, and if stock, the par or, if no par, stated value, if any.

"(b) Amount sold.

"(c) Date of sale.

"(d) Aggregate net cash proceeds, or the nature and aggregate amount of any consideration other than cash, received by the registrant.

"(e) Names of principal underwriters, if any, indicating any such underwriters as are affiliates of the registrant."

Note that this requires the listing of securities issued even though issued upon the exercise of conversion privileges, warrants, options, etc.

[33] See Securities Exchange Act Release No. 79, Jan. 13, 1935, setting forth the opinion of John J. Burns, General Counsel of the Securities and Exchange Commission, as to the manner and extent returns should be filed under §16(a) of the Securities Exchange Act of 1934, in the case of securities held by personal holding companies, partnerships, etc., and Rule NA1 of the Securities and Exchange Commission. See also Exchange Act Releases No. 116, March 9, 1935, No. 175, April 16, 1935.

in turn, stockholders in, or own collateral trust notes of, a company which, in turn, owns securities of the issuer. What is the true meaning of "beneficial interest" in a security?[84] To what extent should the corporate fiction be disregarded?[85] Determining the correct answers to the questions in some cases presents metaphysical questions which would have delighted medieval philosophers compelled to discuss such prosaic subjects as "how many angels can dance on the point of a pin," but as practical, everyday lawyers we may perhaps be excused for wondering at what point it is unwise to spend any more of the issuer's money to ascertain the non-ascertainable and also to wonder as to the value of such detailed information to an investor, even if ascertainable. While the issuer is excused, by the Commission's instruction book, from obtaining information where unreasonable effort and expense is involved, who is to be the final judge whether unreasonable effort or the expenditure of unreasonable sums of money is necessary to obtain this information?

7. *Investigation of Issuer's Contracts, Pending Litigation, Patents, etc.*

(a) Examining contracts of the issuer and subsidiaries in order to ascertain their materiality and whether they were made in the ordinary course of business in order to determine whether they must be summarized in the answer to Item 41.[86] Cross-examining officers of the issuer and subsidiaries as to the facts surrounding such contracts and ascertaining the following to the extent deemed "material" or appropriate:

(1) How many contracts of a similar nature there are;

(2) The gross profits derived from each contract and the relation thereof to total gross profits;

(3) The estimated net profits derived from each contract to total net profits;

(4) What items are deducted and what are not in arriving at "net profits"; whether the issuer's calculation of "net profits" is correct;

(5) Whether the contract originally called for installation of special machinery to manufacture the article called for by the contract, which machinery could not be utilized in whole or in part to manufacture other products in case the contract were cancelled;

(6) Whether the contract calls for a product of special specifications for which there is a limited market and whether it would be difficult to make equivalent profits with other products if the contract were cancelled;

(7) Any additional capital outlay, if any, which would be required to compete for ordinary business if the answer to (5) and (6) is "yes" in whole or in part;

(8) Whether the contract contains any unusual features not present in other contracts and whether an average prudent investor should be informed of such features;

[84] See note 33, *supra*.

[85] See BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) 80.

[86] Item 41 in Form A-2 reads as follows:

"Dates of, parties to, and general effect briefly and concisely stated of every material contract not made in the ordinary course of business, to be performed in whole or in part at or after the filing of the registration statement or made not more than two years before such filing. Only such contracts need be set forth as to which the registrant or a subsidiary of the registrant is a party or has succeeded to a party by assumption, assignment or otherwise, or has a beneficial interest."

See also Instruction Book for Form A-2 with respect to this item.

(9) Whether the contract calls for the sale or purchase of goods above or below the market. If the sales price is above the market, whether such price is apt to affect the financial condition of the purchaser from the issuer so as to threaten its continued ability to take deliveries under the contract, and if so whether the issuer could obtain another purchaser, and at what price. If the sales price is below the current market, whether it is apt to affect the financial condition of the issuer and whether possible losses therefrom have been reserved against. If reserved against, in what manner was the reserve arrived at and is it reasonable and adequate. If the contract calls for the purchase of goods below the market, will the termination or cancellation of the contract affect future earnings, and is it sufficiently material to warrant the placing of a footnote in the earnings statement. And if it calls for the purchase of goods above the market, will it affect the issuer's ability to sell its goods at a profit.

(10) Will the loss of the product called for by the contract, if the contract is cancelled, substantially affect the cost of producing the remaining product sold to others so that the ability of the issuer to compete would be substantially affected.

(11) Checking the judgment of officers of the issuer on the above matters with others.

(12) If the contracts are to be filed with the Commission as confidential, pursuant to Rule 580,[37] determine whether, even if the Commission grants confidential treatment, the substance of the contracts should be revealed in order to inform an investor in accordance with common law principles of disclosure.

(13) Examining contract and in the light of new laws, such as the Robinson-Patman Act, and considering whether any notes should be appended to the income accounts because of possible changes in earnings, etc.

[37] "Rule 580. *Non-disclosure of Contract Provisions.* Public disclosure will not be made of the provisions of any material contract or portion thereof if the Commission determines that such disclosure would impair the value of the contract and is not necessary for the protection of investors. In any case where the registrant desires the Commission to make such a determination, the procedure set forth below shall be followed:

(a) The registrant shall omit from the registration statement as originally filed any reference to or copy of the portion of the contract which it desires to keep undisclosed, or, if the registrant desires to keep the entire contract undisclosed, any reference to or copy of the contract.

(b) The registrant shall file with the registration statement, but not bound as part thereof, (i) three copies of the contract or portion thereof which it desires to keep undisclosed, clearly marked "Confidential," and (ii) an application for an order making the above described determination. Such applications shall set forth the considerations relied upon for obtaining such order.

(c) Pending the granting or denial by the Commission of an application filed in accordance with paragraph (b), the terms and existence of the contract or portion thereof will be kept undisclosed.

(d) If the Commission determines that the application shall be granted, an order to that effect will be entered.

(e) Prior to any determination denying the application, confirmed telegraphic notice of an opportunity for hearing, at a specified time within ten days after the dispatch of such notice, will be sent to the agent for service.

(f) If after such hearing the Commission determines that the application shall be granted, an order to that effect will be entered.

(g) If after such hearing the Commission denies the application, confirmed telegraphic notice of the order of denial will be sent to the agent for service. In such case, within ten days after the dispatch of such notice, the registrant shall have the right to withdraw the registration statement in accordance with the terms of Rule 960, but without the necessity of stating any grounds for the withdrawal or of obtaining the further assent of the Commission. In the event of such withdrawal, the contract or portion thereof filed confidentially will be returned to the registrant.

(h) If the registration statement is not withdrawn pursuant to paragraph (g), the contract or portion thereof filed confidentially will be made available for public inspection as part of the registration statement; and the registrant shall amend the registration statement to include all information required to be set forth in regard to such contract or portion thereof."

See, however, Securities Act Release No. 1292, Feb. 26, 1937.

(14) Determining whether contracts which have expired or are about to expire should be noted in connection with the income account.

(b) Examining all papers and pleadings in pending or threatened litigation. Cross-examining officers and others as to the facts and materiality of such suits. Obtaining summarization of pleadings by counsel in charge and his consent to its use in reply to Item 40.

(c) Consulting with patent or copyright counsel as to importance of patents or trade names in carrying on business of issuer and obtaining, if necessary, statement by engineer or other industrial expert or patent or copyright counsel or both, as to the part patents or trade names play. Obtaining from patent or copyright counsel summary of any material patent litigation and, if necessary, having patent or copyright counsel certify as an expert the answers to Item 40.[38]

(d) Cross-examining officers whether they know of anything in relation to issuer and its affairs that an average prudent investor should know, even though not specifically called for by the form, such as, for example, any pronounced change in the trend of gross sales or net income, etc.

(e) Sending questionnaire to all experts so as to be able to answer Item 44.[39]

8. *Checking Pertinent Corporate Documents, Statements, and Reports, and Status of Outstanding Securities.*

(a) Arranging with the secretary of the issuer for the collection of certified copies of charters, by-laws, indentures, contracts, franchises and other supporting documents; having them proof-read against originals and having the summarization thereof in the registration statement checked for accuracy.

(b) Checking information in all questions and in financial statements with recent annual reports, reports to trustees, listing applications on stock exchanges, reports to public bodies, income tax returns, correspondence, etc.

(c) Arranging for correlation of all work by examining all data presented, straightening out inconsistencies, obtaining additional information, filling in the gaps in the information and rechecking all of the answers in the light of all of the information at hand. In case the utility has been included in the Federal Trade Commission investigation, examining Federal Trade Commission reports for comments on write-ups, etc.

[38] Item 40 in Form A-2 reads as follows:

"Outline briefly the substance of the claims involved in, and state the title of, any material pending legal proceeding to which the registrant or one of its subsidiaries is a party or of which property of the registrant or of one of its subsidiaries is the subject, if such proceeding departs from the ordinary routine litigation incident to the kind of business conducted by the registrant or its subsidiaries, as the case may be; make a similar statement as to any such proceeding known to be contemplated by governmental authorities."

[39] Item 44 in Form A-2 reads as follows:

"If any expert named in the registration statement as having prepared or certified any part of the statement (a) has any interest of a substantial nature in the registrant or any affiliate thereof or is to receive any such interest as a payment for such statement or (b) is an officer or employee of the registrant or any affiliate thereof, or (c) has been employed upon a contingent basis; furnish a brief statement of the nature of such interest, office, employment or contingent basis."

(d) Arranging for and obtaining certificate from each transfer agent, registrar and warrant agent and from each trustee of an indenture as to securities of each class of issuer outstanding as of date of latest balance sheet of registrant filed with statement and of any material changes since then, and checking with answers to Items 9A and B, 10A and B, 11A and B, 12A and B and 13A and B.[40] Obtaining statement from each trustee as to amount of securities pledged and in any sinking fund.

9. *Conferences on Registration Statement and Prospectus.*

(a) Arranging for circulation of drafts of registration statement and prospectus among directors, officers of the issuer, engineers, accountants, underwriters, lawyers for the underwriters, and if need be lawyers for the accountants, and arranging for conferences at which everyone's comments will be gone over and checked.

(b) Arranging for meeting or series of meetings between principal executive officers of issuer, its counsel and underwriters and underwriters' counsel, the accounting and engineering experts to clear program, documents, text of registration statement, etc., and to enable underwriters to ask any questions that have occurred to them in their investigation of the issuer and its affairs and in their examination of the registration statement.[41]

[40] These items call for detailed information with respect to authorized funded debt; funded debt to be offered under the registration statement; each class of authorized capital stock; capital stock to be offered under the registration statement; information with respect to each class of securities of other issuers guaranteed by the issuer; guaranteed securities to be offered under the registration statement; warrants or rights granted by the issuer to subscribe for or purchase securities of the issuer; warrants to be offered under the particular registration statement; information with respect to any other class of securities not previously called for by Items 9A, 10A, 11A, and 12A; and information with respect to any class of securities other than those called for by Items 9B, 10B, 11B and 12B, to be offered under the particular registration statement.

[41] Such meetings have been described as presenting a "somewhat ludicrous picture of partners or perhaps office boys representing the ten, twenty, or more underwriters meeting in solemn session to 'investigate' the accuracy and sufficiency of the registration statement by having it read to them by counsel. When a law demands the impracticable it is not surprising to find business men performing rituals which are apt to be meaningful only to lawyers." See Bates, *Some Effects of the Securities Act upon Investment Banking Practices* (Jan. 1937) 4 LAW AND CONTEMPORARY PROBLEMS, 72, at 77.

If the only purpose of these meetings was to have the registration statement read by counsel, then that would present a somewhat ludicrous picture. One of the anomalies of the Act, however, may be that an "originating underwriter" may be able to sustain the burden of proof because of the thoroughness of the investigation made by its buying department, whereas a small underwriter with a limited participation would not, as a practical matter, make the same investigation. The writer has therefore advised all underwriters where they are not originating the issue, that they should carefully examine the registration statement and prospectus and that they should have some one in their buying department make a careful examination of the registration statement and prospectus, and has recommended to originating underwriters that they should afford non-originating underwriters full opportunity to cross-examine the members of their buying department making the investigation, the officers of the issuer, counsel for the underwriters, counsel for the company and the accountants certifying to the financial statements in order that all questions occurring to any of the underwriters in connection with the issue, the registration statement or the prospectus may be cleared up. The writer has never known office boys to attend such meetings and would not advise such a procedure. In view of the attempts of the Commission to limit the statements which can be made upon the authority of an expert (see note 30, *supra*) and since the Commission has never expressly ruled that a non-originating underwriter can rely upon the investigation made by the originating underwriter, it would seem that such meetings are more than "ritual." Since, in the event of suit one underwriter can receive contribution from another (unless he is guilty of fraud) in accordance with the provisions of §11(f), it is also advisable that the originating underwriter be careful to disclose everything that his investigation has revealed to a non-originating underwriter.

10. *Arrangements for Authorization of Issuance, Sale, and Listing of Proposed Issue.*

(a) Arranging to file application with all state commissions, Federal Power Commission[42] and Securities and Exchange Commission,[43] if the issuer is a subsidiary of a registered holding company and is not otherwise exempt, and with all other public regulatory bodies having jurisdiction, asking for permission to issue and sell the securities at a price to be fixed, asking for authority to continue to amortize, for a period to be agreed upon, the remaining unamortized portion of the bond discount applicable to the issue to be refunded, etc., and preparing the necessary papers.

(b) Holding hearings on such applications before all such public regulatory bodies having jurisdiction.

(c) Obtaining order to sell the securities from each public regulatory body having jurisdiction.

(d) Arranging for qualifying the proposed issue under "Blue Sky" laws of various states in which it is proposed to offer and obtaining clearance in time to offer, and examining provisions of such laws to see if they have particular requirements as to what may and may not be said in the title or the text of securities.[44]

(e) Arranging for reserving of space for underwriters' advertisement in newspapers on morning of offering,[45] clearing a hedge clause with Blue Sky Commissioner in each state where advertisement is to be published in case the names of the underwriters who are not qualified dealers in that state are to appear in the advertisement.

(f) Arranging to have listing applications prepared and cleared with all listing committees on national securities exchanges on which it is proposed to list the bonds, preparing Form 10 or other appropriate form under the Securities Exchange Act of 1934, and requesting an order of the Commission making registration under the Securities Exchange Act of 1934 effective on the morning of the offering or as soon thereafter as possible.

11. *Arrangements for Underwriting Agreement and "Red Herring" Prospectus.*

(a) Arranging for drafting of purchase contract (contract between several underwriters and issuer, sometimes known as underwriting contract), underwriting agree-

[42] See Federal Water Power Act, Part II, §204(a), 49 STAT. 850, 16 U. S. C., c., 12, §824c.

[43] See Public Utility Act of 1935, Tit. I, §6, 49 STAT. 814, 15 U. S. C., c. 2C, §79f.

[44] The information called for by these various state laws, the procedure thereunder and the theory on which these laws are enacted, are wide and varied.

See Smith, *The Relation of Federal and State Securities Laws, infra,* p. 241. ED.

[45] Ordinarily, a registration statement, unless delaying amendments are filed or unless the Commission finds deficiencies which cannot be corrected by amendment satisfactory to the Commission, becomes effective on the twentieth day after the date of its filing. The effective date is therefore 12:01 A.M. on the morning of the effective date. In the summer time, however, New York is on Eastern Daylight Saving Time, and Washington, D. C. is on Eastern Standard Time, and the effective date is 1:01 A.M. Eastern Daylight Saving Time. Certain lawyers believe it improper, under Section 5 of the Act, to allow advertisements of the securities to appear in the newspapers which are on the streets before the true effective date, although this causes real inconvenience and expense to newspapers. See, however, correspondence between Judge John J. Burns, General Counsel of the Securities and Exchange Commission, and *The Boston Post,* June 13, 15, and 18, 1936.

ment (agreement between several underwriters), selling group agreements (arrangements between underwriters and dealers), etc., and for summarization of purchase contract and of selling arrangements in registration statement and prospectus.

(b) Ascertaining from the underwriters if they wish to have inserted in the agreement between the underwriters any right to trade in the outstanding securities of the issuer or to trade in the securities to be offered or to over-allot them or to go short with respect to them, the advisability of including such agreements being a matter of opinion, concerning which there is considerable disagreement because of the rigorousness of Section 9(a)(2) of the Securities Exchange Act of 1934; ascertaining whether the securities are to be listed and conferring with underwriters with respect to Section 9 of the Securities Exchange Act of 1934 and Section 15 of that Act if the securities are not to be listed; arranging to have a paragraph in the underwriting agreement authorizing the manager of the underwriting group to trade in the securities; arranging to have it included in the prospectus and to have a provision placed upon the front of the prospectus reading substantially as follows:

"For further details as to the terms of the offering and for a statement as to the purchases and sales of bonds or of other securities of the company which may be made in connection with the marketing of the bonds or otherwise by the several underwriters, or by ....., as representative of the several underwriters, for their several accounts, either for long or short account, in the open market or otherwise, within the limits and for the periods set forth in the agreements hereinafter referred to, see page .... of this prospectus."[46]

(c) Arranging to have the underwriters circulate "red herring" prospectus among dealers and to circulate "red herring" letters to dealers, announcing the terms of

[46] In addition to considering the provisions of §9 and §15 of the Securities Exchange Act of 1934 as to how far underwriters may lawfully go in trading in securities without violating the provisions of the Securities Exchange Act of 1934, there must also be considered the fact that the public should probably be advised that the underwriters have traded in or proposed to trade in securities of the issuer, including the securities to be offered. See U. S. v. Brown, 5 F. Supp. 81 (S. D. N. Y. 1933); Harper v. Crenshaw, 82 F. (2d) 845 (Ct. App. D. C. 1936) (holding, Groner and Stephens, JJ., dissenting, that a trading account formed by stockholders and directors attempting to support the market in the stock of a bank in which they were interested might mislead buyers and sellers as to the true market value of the stock and therefore such account was void as against public policy). *Cf.* Sanderson and Levi v. The British Westralian Mines and Share Corp. (Ltd.) reported in the *Times* (London) Nov. 10, 1898, and set forth in full as an appendix to Judge Woolsey's opinion in U. S. v. Brown, *supra*, to indicate that all pool operations are not bad. In the Sanderson case, pool operations were conducted so as to permit the holder of a large block of stock listed on the London Stock Exchange to liquidate his shares without ruining the then existing market for the shares. See also Willcox et al. v. Harriman Securities Corp., 10 F. Supp. 532 (S. D. N. Y. 1933); Scott v. Brown [1892] 2 Q. B. 724; Berle, *Liability for Stock Market Manipulation* (1931) 31 COL. L. REV. 264. See also Securities and Exchange Commission v. Torr *et al.*, 15 F. Supp. 315 (S. D. N. Y. 1936), (decree granting temporary injunction reversed, C. C. A. 2nd, Jan. 18, 1937); Securities and Exchange Commission v. Otis Co. (E. Div., N. D. Ohio, Dec. 8, 1936). See also Securities Act Release No. 748 and Securities Exchange Act Release No. 605, April 17, 1936, stating that "certain stabilizing operations do not fall within the prohibitions against manipulation set out in Section 9(a)(2)." At the time this article was written, the Commission had not yet promulgated regulations making certain practices unlawful, pursuant to the authority conferred upon it by §9(a)(6) of the Securities Exchange Act of 1934.

the proposed offering except price, commission to dealers, etc.,[47] so that dealers may investigate merits of issue prior to actual offering.

12. *Preparation of Prospectus.*

(a) Drafting prospectus after registration statement is in practically final form, checking against "Instructions as to the Prospectus" and clearing with all interested parties. The preparation of the prospectus, if well done, is a task of considerable magnitude. There has been criticism of their length and complexity and of the rôle lawyers play in the drafting of them.[48] The writer believes the prospectus can be made a readable and an intelligent document and has, in common with other lawyers of his acquaintance, spent many hours attempting to make them read clearly, but he believes the Commission will have to authorize the omission of a greater number of items in the registration statement and the prospectus or that the liability provisions of the Act itself will have to be overhauled before real improvement, in the form of materially shorter prospectuses, may be expected. Everyone knows it is

[47] The "red herring" referred to above generally reads substantially as follows:

"A registration statement relating to the securities referred to herein has been filed with the Securities and Exchange Commission, but has not yet become effective. Information contained herein is for informative purposes only and is subject to correction and change without notice. Under no circumstances is it to be considered a prospectus or as an offer to sell or the solicitation of an offer to buy the securities referred to herein."

It is a criminal offense to sell or offer to sell securities with respect to which a registration statement has been filed prior to the effective date thereof and any one selling securities during the 20-day waiting period violates §5 of the Act and thereby subjects himself to civil liability pursuant to §12(1) of the Act. However, the theory of the waiting period is that dealers and the public should be informed as to the terms of the proposed security during such 20-day waiting period. While the distinction between merely circularizing information and selling or offering to sell securities within the 20-day waiting period is clear as a matter of theoretical legal definition in the Act itself, as a practical matter it is exceedingly difficult for houses of issue to circularize this information and yet at the same time be able to prove that they did not "offer to sell" or "solicit an offer to buy" within the 20-day period. This is especially true if there is a large demand for the issue, as dealers are very anxious to know how many bonds they may expect "firm" on the date of the public offering. As a practical matter, insurance companies and other large institutional buyers are also furnished with "red herring" registration statements or prospectuses during the 20-day period. Some underwriters also furnish "red herring" prospectuses to their retail customers during this period, but the writer has advised against this because of the practical difficulty first, of being able to control salesmen who are anxious to make a commission, and second, of being able to make the average citizen understand that when a salesman approaches him with information with respect to a security he is not being solicited to make an offer to buy. It would seem to the writer that the entire purpose of the 20-day waiting period would be served and operations under the Act would be greatly clarified if offers to sell or solicitations of offers to buy could be made within the 20-day waiting period, provided that the seller should not be obligated to sell and the buyer should not be obligated to buy until the public offering is actually made. See, however, letter of Baldwin B. Bane, Chief of Securities Division, Federal Trade Commission, incorporated in F. T. C. Release No. 70, Nov. 6, 1933. See also Securities Act Releases No. 464, Aug. 19, 1935, and No. 802, May 23, 1936.

[48] See Address by James M. Landis before Investment Bankers Ass'n of America at Augusta, Ga., on Dec. 4, 1936, reported in *N. Y. Times,* Dec. 5, 1936, p. 29. "*Problems of Prospectus.* Then, there are the problems that flow from the prospectus. The hope that adequate investment information would be widely circulated is perhaps the keynote of the Securities Act. Yet today, in a market that has a plethora of buyers, the selling document too rarely has the attention paid to it that it deserves. Its length results not so much from the requirements of the law, but from the fact that the writing of what should be popular portrayal of business facts is dominated by lawyers nurtured in the drafting of trust indentures. The responsibility for perfecting the mechanism of the prospectus rests not alone upon the Commission. The prospectus must be used, and its purposes honored. Otherwise, the objectives of existing legislation will be far from being reached."

harder to be brief than verbose and when there are no rewards for shorter prospectuses, but rather definite penalties for too concise prospectuses, it is hard to see where the incentive to be brief is going to come from. The writer admits many prospectuses are too prolix, but it must be borne in mind that they are a digest of a registration statement in question and answer form and the penalties for undue condensation are severe.[49] The writer is willing to take his share of the blame, but the record of the Commission itself in this respect is not entirely clear, as an examination of deficiency letters would reveal. While it may be fair to say that "the writing of what should be popular portrayal of business facts is dominated by lawyers nurtured in the drafting of trust indentures,"[50] it is also only fair to say that in the opinion of some lawyers constantly working on security issues, the Commission itself has sometimes insisted that data, the materiality of which has seemed to such lawyers as rather remote, be inserted in the prospectus at the last minute and these lawyers thereafter have not been inclined to take the time to condense lest they be made to reinsert the omitted data. Since enormous inconvenience is caused by the delay of a public offering date, these last-minute requests are not popular, either with lawyers or clients. They are expensive to correct. It is, of course, only fair to say that in certain cases the amendments are filed too late to afford the Commission proper opportunity for examination and that complaints in those instances about changes at the last minute come with ill grace. Generally speaking, the Commission is most coöperative and the writer has always been impressed with the cordial spirit displayed in the Registration Division in helping to get a statement through on time. Coöperation and not "buck passing" is what is needed to solve this difficult problem of prospectuses, and solved it will be. In passing, it is interesting to compare a recent statement of the Chairman of the Commission,[51] urging shorter prospectuses, with House Report No. 85 (at page 8), released at the time the Securities Act of 1933 was under consideration by the Congress:

"The purpose of these sections is to secure for potential buyers the means of understanding the intricacies of the transaction into which they are invited. The full revelations required in the filed 'registration statement' should not be lost in the actual selling process. This requirement will undoubtedly limit the selling arguments hitherto employed. That is its purpose. But even in respect of certain types of listed issues, reputable stock exchanges have already, on their own initiative, recognized the danger of abbreviated selling literature and insisted upon supervising the selling of [*sic*] literature distributed in connection with such issues, to make certain that such literature includes the same information concerning the issue required in a formal circular filed with and approved by such exchanges. Any objection that the compulsory incorporation in selling literature and sales argument of substantially all information concerning the issue, will frighten the buyer with the intricacy of the transaction, states one of the best arguments for the provision. The rank and file of securities buyers who have hitherto bought blindly should be made aware that securities are intricate merchandise."

[49] See Securities Act, §12(2).
[50] See note 48, *supra*.
[51] *Ibid*.

(b) Drafting newspaper prospectus, if one is to be used, and checking against Release No. 523, constituting subdivision "II—Instructions as to Newspaper Prospectuses" in the Instruction Book for Form A-2.[52]

13. *Arrangements for Completion, Execution, Filing and Amendment of Registration Statement.*

(a) Assembling registration statement, supporting documents and prospectus, having portions made on the authority of experts so certified and obtaining their consents to being named as experts and rechecking against form, instruction book and rules and regulations of the Commission.

(b) Examining whole statement and prospectus for any misstatements or any omissions which would make what is stated misleading. Examining prospectus in light of common law principles of disclosure.

(c) Holding board of directors' meeting to pass on and approve registration statement and various matters in connection with the program.

(d) Obtaining signature in behalf of the issuer, by majority of its directors and by its principal executive officers, principal financial officer, principal accounting officer, etc., and filing registration statement and supporting documents with the Commission.

(e) Examining, approximately ten days later, the deficiency letter, if any, received from the Commission. In a well prepared statement, the deficiencies are usually confined to pointing out that the offering price, the "spread" to the bankers, the commission to the dealers, a copy of the underwriting or purchase contract and statement as to the proceeds must be filed before the statement can become effective.[53]

(f) Checking and correcting registration statement and prospectus and if need be holding conference with the Commission concerning alleged deficiencies and preparing and filing amendments to take care of any alleged deficiencies.

(g) Signing of underwriting or purchase contract.

(h) Obtaining signatures to and filing of all amendments, including underwriting contract, public offering price, spread to underwriters and dealers, including twenty copies of prospectus, with Commission with a request that amendments be deemed filed on same date as date of original filing of registration statement so statement will become effective on 20th day after filing pursuant to Section 8(a) of the Act and Rule 945 of the Commission and obtaining order of the Commission to that effect so that public offering can be made on morning of effective date.[54]

[52] A newspaper prospectus is not deemed to be a written prospectus meeting the requirements of §10 for the purpose of §2(10)(a) of the Act. Therefore, the actual securities must be preceded or accompanied by a prospectus meeting the requirements of §10 of the Act or otherwise the seller may be liable for rescission or damage suits under §12(1) for violation of §5 of the Act.

[53] The reason for these omissions from the registration statement when filed is indicated in note 29, *supra*.

[54] Rule 945 reads as follows:

"Rule 945. *Effective Date of Amendment Filed under Section 8(a) with Consent of Commission.*

"A registrant desiring the Commission's consent to the filing of an amendment with the effect provided in Section 8(a) of the Act may apply for such consent at or before the time of filing the amendment. The

14. *Transactions in Connection with Delivery of Securities following Public Offering.*

(a) Bringing of title, franchise and other opinions down to date and examining all proceedings and documents in order to be able to give opinion as to validity of issue.

(b) Clearing form of temporary and definitive bonds with each national securities exchange on which securities are to be listed; giving order for printing of temporary bonds; arranging for signature by company and authentication by trustee.

(c) Arranging for delivery of various officer's certificates called for by underwriting contract, including one setting forth that there have been no material changes since effective date of registration statement except those occurring in the ordinary and normal course of business.

(d) Arranging for delivery of accountant's certificate that there have been no substantial changes in net worth of the company since date of latest balance sheet filed with the registration statement; and having certificates by trustees, transfer agents, etc., brought down to date of closing, setting forth there have been no additional securities issued.

(e) Delivering of securities to underwriters against payment, depositing of money sufficient to redeem outstanding issue with trustee of issue to be redeemed, releasing of the indenture securing the outstanding issue, making arrangements to file the release agreement in all places where property subject to the outstanding mortgage is located, and to file new indenture in all places required by law; and making of arrangements for the publication of the notice of redemption of the outstanding issue in accordance with its terms.

(f) Arranging to obtain affidavit of publication of notice of redemption from proprietors of each newspaper in which it is published.

(g) Arranging to obtain opinion of local counsel that release of indenture securing the outstanding issue and the indenture securing the new issue have been filed and recorded in all of the places required by law.

V

THE DUTY OF THE LAWYER

The task of the lawyer in connection with the offering of securities is, as it has always been, to endeavor to the best of his ability to see that no essentially important element is concealed from the buying public and to approach this task with as great a degree of objectivity as possible. A lawyer must insist that all of his questions be answered fully, fairly and frankly and that no avenues of investigation be closed to him. Otherwise, the sooner he declines to pass upon the issue, the better. He cannot,

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application shall be signed by the registrant and shall state fully the grounds upon which made. The Commission's consent shall be deemed to have been given and the amendment shall be treated as part of the registration statement upon the entry of an order to that effect."

of course, take responsibility for the financial statements, but he should examine them carefully and discuss all accounting questions that occur to him with the executive officers of the issuer and the accountants in order to be sure they have received proper consideration. On difficult questions, he should advise the accountants to consult independent counsel. Any lawyer can give his opinion, assuming all material facts have been revealed to him, that to the best of his knowledge and belief the registration statement on its effective date does not contain a misstatement or an omission of a material fact required to make what is stated not misleading, but he cannot and should not assume responsibility for the accuracy of the data presented (except in so far as it lies within the realm of his personal knowledge) and neither he nor any one can insure that all material facts have been correctly presented and that nothing material has been omitted. Such advice must and never can be more than a lawyer's opinion, *i.e.*, a reasoned conclusion on the basis of the data presented to him and disclosed as a result of his investigation in connection with the preparation of the registration statement. A lawyer can state that in his opinion certain documents and the terms and provisions of the material contracts are properly summarized but he cannot be sure there aren't other material contracts or other facts or factors affecting such contracts that diligent inquiry has not disclosed. Nor can he be sure there aren't contingent liabilities that are not disclosed or other facts which would tend to make what is stated misleading and if he attempts to assure his client that there are no such other facts, and that the registration statement as finally filed does not contain any misstatements of material fact, he may be misleading both his client and the investing public.

In working on a registration statement and prospectus, there is always a tendency to lose sight of the forest because of the trees. The primary purpose of the Act is, of course, to give an investor proper information before he invests. It is not designed to put unnecessary burdens on an issuer nor is it designed primarily to punish the unwary. The statements should therefore be drafted in as simple language as possible in an effort to help the investor. This aim should be stressed rather than stressing the drafting of statements in technical language which has as its primary purpose the protection of the issuer, the underwriters, etc. "Weasel" wording should be avoided.

Moreover, it must be remembered that the steps listed in the preceding section represent only a bare outline of some of the more important tasks which an issuer and its counsel charged with the responsibility of supervising the preparation of a registration statement under the Securities Act of 1933 must consider and decide. In addition to the numerous other questions of substantive law involved, the task involves considering and discussing with the executive officers of the issuer and with the underwriters the legal phases of the program, the best medium for financing and its effect upon the issuer. The great danger is that the preparation of the registration statement and prospectus will cause the consideration of substantive problems

and the substantive drafting to suffer and, of course, this must not be. If the work is started too early, it will cost the company money in double interest in the case of a refunding issue, *i.e.*, interest on the new issue and on the outstanding issue will run at the same time, and, if started too late, the closing schedule cannot be kept, a possibility which is not even to be considered. In general, it must be seen to that everything moves forward from day to day so that the time schedule may be kept, a task made especially difficult by the fact that, in view of the large number of people made liable, there are, of course, many cooks on a registration statement. All must be satisfied or the experts won't certify their particular little portions; and if they won't certify, then the directors won't sign, and then the underwriters and their counsel won't pass it, etc., etc. The lawyer's work is further complicated by the great difficulty which the Commission has encountered in framing precise questions which will be inclusive enough to educe all material facts and yet not be so inclusive as to make the answers to such questions difficult to prepare.

By way of summary, the main problems involved in the preparation of a registration statement may be briefly divided in the following categories:

1. Describing the type of business done, together with the history and development of the issuer. To get this both accurate and concise is difficult.

2. Summarization of complicated legal documents.

3. Obtaining accurate information as to the record ownership and beneficial ownership of securities of the issuer.

4. Determining what are "material" contracts and summarizing the provisions of and reasons why such contracts are deemed material.

5. Determining questions of control and who are or who were "affiliated interests."

6. Determining the cost of property to such persons in control or "affiliated interests," if such property has been or is to be acquired by the issuer.

7. Making sure that proper notes are appended to the balance sheet and income accounts.

VI

PROBLEMS RELATING TO PROPERTY PURCHASES FROM "AFFILIATES" AND "INSIDERS"

The time, expense and work involved in preparing, for example, the answers to some questions relating to these problems, notably Items 29(b), 33, 34, 35 and 38 in Form A-2 and Items 44 and 51 in Form A-1 and Instruction 1A(c) pertaining to the balance sheet of the issuer on Form A-1,[55] seem out of all proportion to their value

[55] Items 29(b), 33, 34, 35 and 38 of Form A-2 are set forth in note 32, *supra*. Items 44 and 51 of Form A-1 and Instruction 1A(c) pertaining to the balance sheet of the issuer in Form A-1, read as follows:

"44. A list of any of such properties purchased from an affiliate directly or through one or more intermediaries, together with the cost of each such property to the affiliated company, if known, and, where such cost is different from the cost to the issuer, a detailed explanation thereof."

"51. If the proceeds or any part of the proceeds of the security to be issued under this registration is to be applied, directly or indirectly, to the purchase of any business, submit a profit and loss statement of such business certified by an independent certified or independent public accountant for the 3 preceding

to the investor. The general character and content of these questions and the abuse of fiduciary relationships in certain outstanding cases in the past, unfortunately complicate the problem confronting honest issuers, underwriters and the Commission. However, an instruction permitting an issuer not to answer these questions, when the amounts involved do not exceed certain sums and when the "interests" of officers, directors, or underwriters in the securities of a vendor of property are not substantial, would be most helpful. For example, an issuer might have or be purchasing property additions from over fifty corporations including such corporations as General Electric, Westinghouse, United States Steel, Anaconda, etc. If, as the Commission claims, property additions are not made in the ordinary course of business the task of checking the "interests" of such persons in such vendors is a large one and the results are usually "nil."

Moreover, since the primary problem in preparing a prospectus is to inform an investor without misleading him, undue emphasis on the bad or so-called "dirt" aspects of an issue may mislead an investor as well as over-enthusiastic selling literature.

For example, some persons lay great stress on whether prospective investors are informed that "insiders" profited on the sale of any property owned by the issuer on the effective date of the registration statement, regardless of the date the issuer acquired the properties,[86] or the date or dates the "insiders" acquired the properties sold. Determining actual cost to "insiders" of property later sold to an issuer is sometimes a most difficult task. Sometimes the property is merely part of a large block acquired as a unit and there is no separate cost for the property sold to the issuer. Other property acquired at the same time may have been sold or exchanged. Changes in the price level between the date of acquisition by the "insider" and the date of sale to an issuer may also distort the result. Or the issuer may have issued securities with little or no market when issued, which the "insider" has carried for several years and then has sold at a time or from time to time when the securities were selling at high levels. A standard of business morality which permits "insiders" to profit at the expense of stockholders is naturally to be deplored and in so far as such transactions are material, complete publicity is essential. But from the stand-

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fiscal years. The profit and loss statement shall be submitted approximately in the form required for the issuer. There shall also be submitted a balance sheet of such business, similarly certified, as of a date not more than 90 days prior to the filing of the registration statement or as of the date such business was acquired by the issuer, if the business was acquired by the issuer more than 90 days prior to the filing of this registration statement. This statement shall be submitted in approximately the same form as required for the issuer. If for any reason it is impossible to present such profit and loss statements or balance sheet, explain fully the circumstances. Consolidated statements for a parent and one or more of its subsidiaries may be furnished in lieu of separate statements of the parent and such subsidiaries."

"Instruction 1A(c). Profits to affiliated interests included therein (if any). If profits of this nature are included in fixed assets, give full details thereof including a brief description of the property, the name of the affiliated interests from whom acquired and the cost of the property to such affiliated interests."

[86] Form A-2 limits the question to property acquired by the issuer within two years of the date of filing the registration statement, but Form A-1 does not contain a similar limitation. See Item 35 in Form A-2, note 32, *supra*, and Item 44 in Form A-1, note 55, *supra*.

point of materiality, the test should be the value of the property on the date of its sale to the issuer and not the price the "insider" paid for it even though such "value" may be difficult to determine. Indeed, the "insider" may have sold property to the issuer at a loss to himself which may still be a bad bargain for the issuer. In the case of new enterprises or in the case of those formed within a few years prior to the filing of the registration statement or in case such property has recently been acquired, the information may be of real value to an investor, but its probative force fades with the years and may, in fact, confuse him. The very fact that stress is laid on the profit to an "insider" on a transaction taking place years ago may tend to make a prospective investor believe that the figures at which properties are carried on a balance sheet as of a recent date are necessarily indicative of their present-day value and he may therefore be misled in his efforts to appraise the true worth of the securities being offered. There are always a great many things one would like to put in a prospectus but, when one has to choose and condense, the test should be "is it really material?" and not "is it interesting or scandalous?"

Much of the difficulty encountered in the preparation of a registration statement also occurs in attempting to determine whether certain persons or groups of persons fall within the definition of "affiliate" laid down by the Commission. For example, in the Instruction Book for Form A-2, the term "affiliate" or "affiliated" refers to a person who directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the registrant. The term "control" is defined as follows:

"The term 'control' (including the terms 'controlling,' 'controlled by' and 'under common control with') as used herein, means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract or otherwise. If in any instance the existence of control is open to reasonable doubt, the registrant may state the material facts pertinent to the possible existence of control, with a disclaimer of any admission of the actual existence of effective control."

Does a person, owning 30% of the voting stock of a particular corporation, possess the power to direct or cause the direction of the management and policies of an issuer? He certainly does not possess the legal power through the ownership of voting securities although he may, in fact, exercise control and domination. Is mere exercise of control and domination sufficient to bring a person within the definition or must he also possess the power to direct? If he possesses the "power to direct" but doesn't use it, is he in "control"? What is the meaning of the phrase "or otherwise"? If a person "controls" the issuer or is "under common control with" the issuer, he is an affiliate and if he is an affiliate, then it is necessary to determine, in answering Item 35,[57] for example, whether he had any substantial interest in any property acquired by the issuer within two years, or proposed to be acquired, not in the ordinary course of business. If it is determined, first, that the person is an

[57] For text of Item 35, see note 32, *supra*.

affiliate, and, second, that he did have a substantial interest in the property acquired by the issuer within two years, and third, that the acquisition was not in the ordinary course of business, then the cost of such property to such affiliate must be determined and the difficulties in this connection have already been touched upon. It will also be necessary to ascertain what is "in the ordinary course of business" in order to ascertain what is "not in the ordinary course of business." For example, the Commission in a recent deficiency letter held that all property additions made within two years or to be bought from the proceeds of the issue were to be deemed to be made not in the ordinary course of business. If we examine for a moment the "Instructions pertaining to Balance Sheets of Issuer" for Form A-1, we find that in Instruction 1 we must set forth:

"Profits to affiliated interests included therein (if any). If profits of this nature are included in fixed assets, give full details thereof including a brief description of the property, the name of the affiliated interests from whom acquired and the cost of the property to such affiliated interests."

It will be noted that a person may have been an "affiliated interest" at the time the property was sold to the issuer, but the records of the issuer available today may not disclose that fact and, even if they do, the records of such "affiliated interests" may not be available to the issuer.

In paragraph 9 of "General Rules as to the Form" in the Instruction Book for Form A-2, it is stated that information need be given only in so far as known or reasonably available to the issuer and that if the information required is not—

"reasonably available to the registrant either because the obtaining thereof would involve unreasonable effort or expense or because it rests peculiarly within the knowledge of another person neither controlling, controlled by nor under common control with the registrant, the registrant shall give such information as it possesses or can acquire with reasonable effort, together with the sources thereof. In such case, there shall be included a statement respectively showing either that unreasonable effort or expense would be involved, or indicating the absence of any relationship of control and the result of a request made to such person for the information; and the registrant may include a disclaimer of responsibility for the accuracy or completeness of the information given relating to that required by the particular item."

The regulation does not say, however, that if a registration statement containing such a disclaimer becomes effective that that is necessarily conclusive evidence that the obtaining of such information would have involved the issuer in unreasonable effort or expense. It therefore frequently becomes necessary to use unreasonable effort and expense in obtaining information of this character because of the worry that a court or jury, at some future time, may find that the obtaining of it would not have involved unreasonable effort or expense. It should also be noted that in order to take advantage of this instruction, it is, in effect, necessary to prove that the information rests peculiarly within the knowledge of another person "neither con-

trolling, controlled by nor under common control with the registrant." Since the concept of "control" does not depend upon the narrow legalistic one of ownership of 51% of the voting stock,[58] it is frequently a difficult task to obtain all of the facts necessary to decide whether "control" or "common control" exists. In addition, it should be noted that in addition to finding the facts, it is also necessary to arrive at a legal conclusion as to whether "control" does or does not exist and if the legal conclusion is wrong, the registration statement may possibly contain a material omission.

VII

WHAT DO BALANCE SHEET FIGURES MEAN?

Contrary to what seems to be the common belief, accounting does not ordinarily concern itself with present-day valuation of assets but rather with the correct presentation of the history of assets according to accepted principles of accounting consistently followed. Of necessity, a balance sheet cannot constantly be adjusted because of changes in the price level and consequently the figures at which fixed assets are carried do not necessarily represent the value at which they can be liquidated. From an economic standpoint, the figures at which assets are carried on the books of an enterprise, provided they are correctly labeled so that an investor may know the basis on which assets are carried, may have little or no significance, although the changes in these figures from year to year may have great significance.[59] It is rather what those assets will earn and cost to keep up that counts. Write-ups or write-downs are important to know in determining whether the management is setting aside enough to retire the property at the end of its useful life and whether the dividends received are earned, but from the standpoint of the true worth of the issuer, such write-ups or write-downs may have little or no significance for an investor, despite the fact that such write-ups or write-downs must be presented for a period as far back as January 1, 1922.[60] As Mr. Hoxsey so clearly points out in an address[61] and as Mr. G. O. May has stated in the numerous papers compiled in his book recently published, *Twenty-five Years of Accounting Responsibility 1911-1936,* write-downs may be as detrimental as write-ups, and where a corporation has reasonably correct historical records of the cost of its plant, these figures should not be

[58] See H. R. REP. No. 85, 73rd Cong., 1st Sess. (1933) p. 14: "The concept of control herein involved is not a narrow one, depending upon a mathematical formula of 51 percent of voting power, but is broadly defined to permit the provisions of the act to become effective wherever the fact of control actually exists."

[59] See exchange of correspondence between the American Institute of Accounts and the Committee on Stock List of the New York Stock Exchange, referred to in note 26, *supra.*

[60] See Item 45, note 22, *supra.*

[61] See Address, *Writing Down Assets and Writing Off Losses* by J. M. B. Hoxsey, Executive Assistant, Committee on Stock List, New York Stock Exchange, before Mass. Society of Certified Public Accountants, Feb. 23, 1933, p. 9; see Address, *The Influence of Accounting on the Development of an Economy* by G. O. May before the American Institute of Accountants, Oct., 1935, p. 8, printed in *The Journal of Accountancy* for January, February and March, 1936. See dissenting opinion of Mr. Justice Brandeis in United Railways v. West, 280 U. S. 234 (1930); see also LIEF, THE SOCIAL AND ECONOMIC VIEWS OF MR. JUSTICE BRANDEIS (1930) 199.

lightly cast aside for other figures which, however accurate, can only be accurate for that instant of time. For example, you build a plant costing $100,000 which earns $20,000 per year and costs $15,000 to run. The writer is given an identical plant, costing the same amount, earning at the same rate and costing the same amount to run. You carry yours in your balance sheet at $100,000 and the writer carries his at 0. Does the figure at which each plant is carried affect either its value, its earning power or its cost of upkeep? If you write yours down to 0 and the writer writes his up to $100,000, have we changed anything? Let us suppose two years later neither plant is earning anything. Must I write my balance sheet figures down? Then let us suppose two years later each plant is earning $30,000. Should we write the balance sheet figures up? The mere statement shows how silly it is to talk about a balance sheet being an instantaneous photograph of the condition of a corporation. Or let us suppose some other organization in 1929 built a plant costing $10,000,000. Let us suppose that the mortgage is foreclosed in 1932 and that the issuer buys this plant at the foreclosure sale for $2,500,000. In 1932 when the foreclosure sale occurs, the plant is closed down and is earning nothing. In 1937 when a registration statement is filed, the plant is running full time and the proposed issuer is receiving substantial net earnings from this plant. Is the stock of Company A which carries this plant on its books at $2,500,000 worth any less than the stock of Company B which carries a similar plant, built at the same time, on its books at $10,000,000 but earning at the same rate? Yet the impression is rather widespread that the figures at which assets are carried on the balance sheet represent their present-day value. And it is this widespread misconception as to the function of accounts that complicates the problem of preparing a registration statement.

VIII

THE VALUE OF THE ACT

There is, of course, an honest difference of opinion as to the value to the investor and the materiality of certain items in Form A-2 and particularly in Forms A-1 and E-1. Some, of whom the writer is not one, doubt the value of the whole method of informing the investor on the ground that the publicity in connection with the Act will mislead investors into thinking they are trading in the full light of day, when this is obviously impossible, since it is the inferences to be drawn from information which is the important thing.

Many persons argue that prospectuses as prepared prior to the Act contained the materially essential elements in connection with an issue. Such prospectuses, when relating to the securities of well known companies or when the securities were being sold by underwriting houses of repute, generally contained, with the addition of certain financial statements, approximately the same information as the Commission now requires in a newspaper prospectus. Therefore people argue that the customary three- and four-page prospectus in use before the passage of the Act told the average

man far more than a complicated registration statement and prospectus, since such a short prospectus represented a screening of the thoughts of trained minds. While much can be said for this point of view, a view held by many honest and competent issuers and underwriters, it must be said with regret that it leaves too much to the individual conscience. An examination of some pre-Act prospectuses will show how ludicrously inadequate some of them were.

The writer is a strong believer in publicity, both as a deterrent to those in fiduciary relationships who, in the past, have not been fully conscious of their obligations, and who might tend to err in the future if their activities were not to be exposed to the light of day, and as a means of building up sound corporate finance.

It seems to the writer that the question is not how much the work on a registration statement costs the issuer, but whether this cost is justified as a necessary social measure in order to prevent the investor from being misled and whether the advantage to the individual investor more than offsets the red tape in which business men and bankers frequently find themselves entangled. Anyone's appraisal of the social worth of the measure will be largely a matter of individual viewpoint. There are those who insist that the advantages of a completely free market, whatever its dangers, and they are legion, outweigh its dangers. Others, conscious of their own moral integrity, resent the interference to their business, the delays and the expense and insist that their businesses are being placed in the hands of theorists, lawyers and accountants. They point out that they built up their business without assistance from the government, that they want none now, and all they want is to be let alone. Others insist that facts with respect to an issuer are not enough; that you must point out that the government is artificially maintaining low money rates and supporting the government bond market and that a rise of 1% in money rates would cause a drastic decline in the market prices of bonds; that new enactments, such as the Robinson-Patman Act, may change the trend of earnings; that the provisions of the Revenue Act of 1936 penalizing the non-payment of dividends have caused unwise disbursements which, in turn, have caused stocks to soar unduly high; that price levels depend on the gold and silver policies, the tariff policies, reciprocal trade agreements and a host of other factors; and that it is impossible to encompass the information an investor should have in a single document and it is misleading to the investor to try.

One can be sympathetic to these viewpoints but after the happenings of the 1920's, completely unregulated security markets seem unthinkable. It may well be doubted that regulation will accomplish all that its enthusiasts claim and too much regulation may be as bad as no regulation at all, but on the whole the writer believes the Securities Act of 1933 and the Securities Exchange Act of 1934, if well administered, are here to stay. Publicity and full revelation, of course, cannot prevent the inexorable operation of economic laws any more than complete regulation of railroads by the I. C. C. could prevent gigantic losses in railroad securities, as new methods of trans-

portation developed. The writer believes that the public will undoubtedly suffer losses in the next depression. Such losses must come as the price society pays for what we are pleased to call progress. If laws can be passed to prevent such losses, then we must be prepared to preserve the status quo and to stifle invention. We can only attempt to see that true and accurate information is made available to investors. We cannot guarantee the future.

In the writer's opinion it is impossible to state what effect the Act will have in accomplishing a simplification of financial structures. Even prior to 1929 the public was beginning to oppose complicated financial structures and of recent years there has been a tendency to avoid the issuance by any one issuer of too many types of securities. Any acts which are designed to inform the public of what their rights are and what are the rights of other security holders of the same issuer, are distinctly helpful. However, the provisions of the Revenue Act of 1936 may tend to undo the good which the Securities Act of 1933 and the Securities Exchange Act of 1934 were accomplishing in this direction inasmuch as a corporation is entitled to receive a dividend-paid credit for the market value of securities which it issues as a taxable dividend.[62] If the Revenue Act of 1936 stays on the books in its present form, many corporations, in order to maintain their working capital, may issue securities as taxable dividends, and as a result we probably shall see some rather peculiar securities issued. On the whole, the larger the corporation, the simpler its corporate structure. Complicated corporate structures have usually arisen either in reorganizations or because various terms and provisions of indentures or of preferred stock issues prevented financing in a more orthodox way. The tendency toward simpler corporate structures is a sound one and it is to be hoped that the present trend toward the issuance of hybrid securities as dividends will not have to continue.

[62] Revenue Act of 1936, §27(d) and (e).

ACCOUNTING ASPECTS OF THE SECURITIES ACT

T. H. SANDERS*

The Act and Accounting

The preamble of the Securities Act of 1933 opens with the statement that it is "An Act to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, . . ." Such a purpose immediately invokes the resources of accounting; the "character of securities" is in large measure revealed in the financial information about the company issuing the securities, as developed in its accounting statements. The history of accounting, ever since it became common for business to be carried on by corporations financed by public issues of securities, has been concerned with the problem of discovering what constituted "full and fair disclosure" and with providing the information which would satisfy the definition. The accounting requirements of the Securities and Exchange Commission are therefore the culmination of a long movement which has had in view the same purposes as those of the Securities Act, and any consideration of the accomplishments of that act would be incomplete without a survey of this historical evolution. In the language of the act itself, such a survey might be said to have "omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading,"[1] and, since this is one of the cardinal sins which the act seeks to prevent in registration statements, it ought also to be avoided in discussions of the act.

Historical Review of Accounting and Investment

Accurate and effective accounting does not flourish in a pioneer country, and until recently most of our people have been proud of the fact that this was a pioneer country. The British poet, speaking of the history of his own country, alluded to "our rough island story"; we have had a correspondingly rough continental story. The principal characters in it were men of immense vigor in action, and it was not to be expected that they would have a scrupulous regard for the niceties of accounting; on the contrary it was extremely difficult for them to understand the necessity for any accounting. The last 50 years have seen a transition from this pioneering

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[1] Securities Act, §11(a).

era to one of more settled and organized industry, which may reasonably be expected to live up to more orderly rules. As progress is made, however, it is not necessary to reflect too severely upon those who in an earlier day acted according to the conditions of their time. The change in the character of business has arisen in part from the change in the basis of financing it; to an ever-increasing degree its securities have been offered to the public, in order that they might participate in what at one time was spoken of approvingly as "the democratization of industry." And now the Securities and Exchange Commission lays down its rules with the dictum: "A nation of investors deserves, at least, this slight protection."[2]

The first great public issues of securities in this country, other than governmental, were largely those of the railroads, and some of the earliest corporate reorganizations in which large blocks of security values were extinguished occurred in that field. Nevertheless the Interstate Commerce Act of 1887 was more a movement of shippers than of investors; shippers were much more numerous than investors, and since a considerable proportion of these securities was floated in foreign countries, it is not impossible that Congress was in part influenced by the fact that customers of the railroads were voters, while investors in them were not. In any case the Interstate Commerce Commission gave its early attention to rates, but also introduced accounting methods which gradually became a major factor in its public control. The same has been true of public utility commissions, and of federal and state bodies for the supervision of banks and insurance companies.

The United States Steel Corporation has, from its foundation in 1900, practised a high level of "full and fair disclosure," and has been followed by other industrial corporations. The New York Stock Exchange has not been indifferent to "the character of securities sold," but under the leadership of some of its officers has for years fought conscientiously for precisely those causes which in the Securities Act were taken up by the federal government. In these efforts it has been well supported by the public accounting profession.

What then were the weaknesses which made the Securities Act necessary? Broadly speaking, these agencies constituted an inadequate coverage of the problem, and in many cases did not have the requisite power to enforce their standards. Although railroad and utility securities represented a large segment in the financial activities of the nation, the commissions which supervised them necessarily left untouched the still greater areas of industrial, commercial, and financial securities. Other than the common law itself, with its general rules against fraudulent dealings, the exchanges were the principal bodies in a position to do something in the direction of improving accounting standards. Although the New York Stock Exchange was the most powerful of these, there were 35 other exchanges on which securities were traded in, and while some of these endeavored to follow the lead of the New York Stock Exchange, the majority of them were less concerned about the problems involved, or at least weak in their attack upon them. The New York Stock Ex-

[2] *In re* Haddam Distillers Corp., 1 S. E. C. 37 (1934).

change itself could proceed only step by step, at such pace as it could make with the consent of the listed corporations. As more stringent accounting requirements were found to be necessary, the Exchange might be successful in inserting them in new agreements for the listing of new issues, but was not in a position to rewrite its existing agreements. Corporations could insist upon their contractual rights, and there was a lag in the extent to which the great body of listed corporations was under obligation to live up to the latest accounting requirements. Yet the Stock Exchange had some success in winning the general consent of the corporations to periodic movements which had the effect of raising the general level of accounting and reporting performance.

Contribution of the Securities Act

In these circumstances what contribution has been made under the Securities Act to the better public reporting of corporate financial condition? It must be remembered that, even when the published balance sheet and income statement gave only meagre summaries, omitted significant matters, or even made direct misrepresentation of financial condition, the internal records of the company were frequently sufficiently reliable and detailed to afford a true picture to those who had access to them. But this of course was the sort of thing which the authors of the Securities Act aimed to remedy, that privileged insiders should have one picture of the situation —a reasonably complete and true one, while the outside public had another picture— incomplete if not definitely erroneous. While many leading corporations were following a reporting practice which carried a high degree of reliability, in the sense that those who had only the published reports of the company saw the picture substantially as the directors and officers saw it, and no items which would materially change that picture were withheld, yet for the reasons already given other corporations failed to live up to this standard, and in their cases it has not been true that a complete and accurate picture of the company's finances was publicly available. The effects of the Securities Act have been, first, to strengthen the hands of all those who were already working for better accounting, placing them in a position to insist even more stoutly upon what they conceived to be called for by a high standard of reporting and, second, to bring all corporations coming within the sway of the Commission up to the level of the best. Thus reform and improvement were brought about, and in one step advanced to a level which would have taken years to develop if left to the voluntary efforts of private agencies. This was the objective sought for, and there is little doubt in the minds of those familiar with the work of the Commission that it is in fair way of realization. The investment banking community, which at first was so much alarmed by this legislation, has come to recognize that the general tone and character of their business has by it been greatly improved. The more responsible members of the profession have less fear that competitors will take business away from them by using less exacting standards of accounting, calculated to make the preparation of the issue cheaper for the issuer,

and at the same time perhaps to enable the securities to be presented to the public in a more favorable light than they really deserved, by suppressing the more unattractive features of the company's status. Many members of the investment banking profession would be greatly disturbed if adverse court decisions should tend to destroy the salutary influences of the Commission.

Two Classes of Corporations

One of the most constructive policies adopted by the Commission was that which led it to distinguish between old-established, reputable corporations with a known position and newer, mostly smaller, promotions still in a speculative stage. There can be no doubt that the former group had been unnecessarily burdened with regulations aimed primarily at the latter group, though the two situations present problems of entirely different character. With the newer companies scrutiny must necessarily be severe, in some cases to the point of prohibition; but seasoned corporations cannot reasonably be dealt with in the same manner. The Commission early recognized this important difference when it made the newer and more liberal requirements of Form A-2 available only to the latter class of corporations, while those not yet having a record of accomplishment were still required to register on the more exacting and arbitrary Form A-1. That the Commission did wisely in making this distinction will be evident from a very brief study of the list of 129 registration statements as to which stop orders, consent-refusal orders, and withdrawal orders were issued between September 1, 1934, and June 30, 1935.[3] Only one was submitted under Form A-2; a number were prepared on special forms, but the great majority were on Form A-1. Of the companies making these offerings, not more than one or two have anything approaching a national standing and reputation; practically all of them represent purely local ventures, and many were of obviously unsubstantial character. The traditional reputation of mining stocks for fantasy and delusion is well borne out by this list; and, to a certain extent, so is the remark frequently made by members of the Commission in its early months to the effect that no reputable company need be apprehensive about registration. This list of forbidden issues well illustrates the two distinct phases of the Commission's work. Corporations of good standing, with years of satisfactory history behind them, find the problem of compliance with the Commission's requirements a relatively simple matter; most of them have nothing to conceal, and it is a question only of compiling the information required, in form and substance acceptable to the Commission. But in the second group are many dubious and border-line issues, about which there is reasonable question as to whether a public offering should be permitted or not, and if permitted, there can be no question that full information of their hazardous and speculative character should be furnished to investors before they buy. In the future evolution of the Commission's financial requirements, it is altogether desirable that

[3] S. E. C., FIRST ANN. REP. (1935) 67-70. The projects listed were, however, not all without merit. Something like 25% of the stop orders were subsequently lifted by the Commission upon the filing of proper amendments to the registration statements.

this distinction be maintained, and indeed extended as far as possible. While, therefore, the Commission's task with newer promotions is predominantly police duty, with established corporations it is rather the constructive task of inquiring how situations generally sound may be presented in the most revealing light. In the latter area are included (1) problems which arise from the historical character of the balance sheet and (2) problems arising from those aspects of accounting which are largely a matter of the exercise of intelligent opinion. The two groups are not distinct; they overlap considerably, but form a convenient basis for discussion.

Problems Arising from the Historical Character of the Balance Sheet

When Congress specified "a balance sheet as of a date not more than 90 days prior to the date of filing,"[4] which balance sheet must contain no untrue statements, or omissions likely to mislead, it doubtless was thinking of the balance sheet mainly as it is customarily described in its own heading, a statement of financial condition as of a specified date; in other words, a statement of *present* condition. But one of the dominant characteristics of this financial statement is the extent to which both asset and liability items are carried forward from one financial period to another. The result is a continuous and extensive overlapping; all balance sheets are greatly influenced by large transactions and outlays of the past which have a bearing on the present and on long periods to come; similarly in every fiscal period many such transactions are undertaken, but their effect will not be exhausted within the current period, and a large part of the amount involved must be carried forward for proration over future periods. The balance sheet thus carries within itself the effects of all the financial and accounting policies followed by the company since the beginning of its history, just as a man's body is said to contain all the marks of his entire medical history since birth. In the quest for a true balance sheet, therefore, how far should the Commission insist upon review and correction of the past, not so much with the object of retroactive accounting, but rather in the interest of a true balance sheet for the present and for the future? A literal compliance with the statute might be construed to require such an overhauling of earlier history, but the plain facts are first, that such a procedure would have involved the Commission and issuing companies alike in an interminable morass of doubts and uncertainties surrounding past transactions reflected in present balance sheets; and second, that the beneficial effect of these mountainous labors would have been almost precisely nil. The Commission therefore did wisely when it availed itself of the wide discretion accorded to it in the act and cut its way through this Gordian knot by a few bold decisions. One of the general circumstances which tended to embarrass the Federal Trade Commission's administration of this act was that it did not take a similar stand on this issue.

Property and Plant Accounts

The balance sheet required must show "all of the assets of the issuer, the nature and cost thereof, whenever determinable, in such detail and in such form as the

[4] Securities Act, Sched. A.

Commission shall prescribe."[5] This requirement immediately brings up the subject of the long-time property and plant assets, which are frequently the largest items in the balance sheets of industrial, mining, utility, and transportation companies. Every such company must make for itself working rules as to what expenditures upon property it shall charge to capital, thus increasing the property account in the balance sheet, and what it shall charge against income, thus increasing maintenance expense, reducing net income, and adding nothing to the stated value of the property. The converse problems arise when property is retired. Exactly how have the retirements been dealt with, and what subtractions have been made from the property accounts with respect to them? A third group of problems is continuously present in the basis and the rate at which these property assets are to be written off by process of depreciation. Everything which has been done with respect to all these matters since the inception of the company is reflected in the balances of the accounts which now appear in the balance sheet as property assets, with their corresponding reserves. In many cases the records of these past transactions have been destroyed; frequently errors on one side have been offset by compensating errors on the other, so that the present results are broadly correct. The problem is not only of the determination of facts, and a correct accounting for them, but also involves the exercise of judgment as to what is a sound treatment.

All of these problems arise, in endlessly various forms, in the quest for a correct statement of the assets "at cost." What then shall be done about the numerous valuations and revaluations of property in which cost has been abandoned, and the effort made to state property assets at somebody's conception of their present value? Where these valuations have synchronized with a reorganization, or the transfer of the assets to a different corporation, the new value might be construed as being the effective cost to the new owner, and thus satisfy the letter of the law. But then in numerous instances arises the question in which property was acquired not for a money cost but for a cost consisting of securities issued. It is a well-known fact that such securities, with their par or stated values largely within the discretion of the officers and directors issuing them, have been handed out far more freely than cash would have been, and no experienced person is under any delusions as to an identity between a security price and a cash price paid for properties.

In its search for a satisfactory solution to these various problems, one that it might conscientiously regard as fulfilling the spirit of the law, the Commission has taken a firm stand, based on one hand on what was practically possible, and on the other on a clear perception of the difference between form and substance. The Commission's original accounting requirements were embodied in the instruction book for Form 10, the form applicable to the Securities Exchange Act, but these same regulations were soon afterwards adopted, with the necessary modifications, for Form A-2, the Commission's new form under the Securities Act. This solution in effect consisted of the following steps:

[5] *Ibid.*

1. Property and plant items were required to be stated in the balance sheet with references to a Schedule II, to be attached.[6]

2. Schedule II listed the property by main groups and required for each group (a) the opening balance "at the beginning of the first period of audit" which "may be as per accounts," (b) additions during the year at cost, (c) subtractions during the year, (d) balance at the end of the year, being the amount shown in the balance sheet.

3. The requirement of opening balances at the beginning of the first period of audit as the first money column in Schedule II had the effect of avoiding a great many inconsequential questions with regard to the past history of the plant account. As to matters of real substance, however, in which the opening balances might turn out to be misleading, the situation was safeguarded in two ways, one being an action of the Commission, and the other an effect of the law. Having in mind the numerous revaluations which have taken place, mostly upward in the 1920's and downward in the 1930's, and accepting to some extent the view frequently expressed by accountants of wide experience, the Commission added to its balance sheet requirements another set of questions under the title "Historical Financial Information,"[7] in which the issuer is required to give particulars of any substantial revaluations of the plant assets which have been made by the company since January 1, 1922. The earliest registration statements coming before the Commission would contain income statements going back to January 1, 1932, and therefore this supplementary question covered a ten-year period prior to that date. The result is that if the plant accounts represent anything other than cost, at least as regards the preceding ten-year period, what they do represent will be brought out. The other safeguard to the situation lay, as stated, in the law itself. If there should be any elements in the plant accounts not reasonably representing either a true cost or a true value of the property, and if this discrepancy could be construed as a misstatement of a material fact, then the parties to the registration statement would be exposed to the provisions of the act, first as to stop order proceedings, and next as to the liabilities there provided. If, therefore, the amount shown in the balance sheet for plant has anything unusual in its make-up, the issuers and their advisers are bound to give such explanatory description as will make the situation clear, even though this is not specifically called for in the regulations of the Commission. In fact, the regulations contain a clause to the effect that they do not purport to be exhaustive, that they constitute a minimum requirement,[8] and that the company should furnish any other information necessary to make the description complete and true.

Intangible Assets

Following upon the requirements as to the assets of the issuer comes the clause "(with intangible items segregated)."[9] This involves another problem which, now

[6] Instruction Book for Form A-2 for Corporations. [7] Form A-2, Question 45.
[8] Instructions for Form A-2, General Requirements for All [Financial] Statements.
[9] Securities Act, Sched. A, par. 25.

that the requirements are known, will be relatively easy to deal with hereafter; but in the past it has not been customary to make this segregation, and it is an almost impossible task to observe the distinction, on any reasonable basis, with respect to old properties. The typical situation, and the one which best reflects the difficulties, is that in which a parent company has acquired a majority of the capital stock of a subsidiary, at prices substantially in excess of the net book value of the subsidiary. Probably the subsidiary has no intangibles recorded in its own books, and the officers of the parent company completed the transaction on the basis of the estimated future earning power of the subsidiary and its expected value as a member of the consolidated group. But they did not expressly state whether the amount paid over and above the net book value of the subsidiary represented a new valuation of its tangible assets, or was invested in intangible assets, or partly both. In the then general level of accounting practices this was not at the time a culpable oversight, since the officers had no occasion to make any such subdivision of the purchase price for their own purposes; all that was necessary was to enter the securities in their own books as investments at cost price in one amount. But later, in the preparation of a consolidated balance sheet, the problem confronted them of dealing with the excess amounts paid for the subsidiaries. If in the consolidation the excess amounts were eliminated altogether, then the resulting aggregate figure would represent only tangible assets at the cost or book value to the subsidiaries, unless the latter carried intangibles on their own books; but, if the more usual practice were followed of including the carrying value of the investments in the consolidated balance sheet, then it would be necessary to apply to the resulting aggregate property account an appropriate description, which usually took the form of some reference, in the detailed title under which the plant item was presented, to goodwill or other intangible assets.

The Commission dealt with this situation by requiring intangible assets to be shown as a separate item in the balance sheet, accompanied by a separate explanatory schedule showing the balance at the beginning of the period, the changes during the period, and the balance at the end of the period as appearing in the current balance sheet. But the instructions on this schedule stated that, if in the books of the issuer intangible assets had not been kept separate from tangibles, then the two might be combined in the balance sheet and in one schedule. This was no more than a frank recognition of existing facts; to have gone further and required a separation of the two items in all cases would have greatly enhanced the difficulties of preparation of the statements, would have kept alive the fears and apprehensions with which the original requirements were regarded, and would have resulted only in arbitrary figures which would have done very little to aid any investor in arriving at a clearer perception of the true condition of the business.

These difficulties were well illustrated in the case of the American Smelting and Refining Company, which in April, 1935, undertook voluntarily to make a separation

of tangibles and intangibles hitherto combined. After reciting the penalties imposed by the act for false statements, and alluding to the option allowed to the company by the Commission's regulations, the directors and officers somewhat reluctantly concluded that they should make an effort to effect the separation, while intimating rather plainly that they were not too confident of the results. The company had been formed, they stated, by the acquisition of a number of going concerns, for which they necessarily had to pay something more than their net book values. All these properties were shown in the balance sheet for December 31, 1934, in one aggregate sum described:

Capital Assets:

Property—Cost of plants, properties of subsidiary companies and additions and improvements, including patents, licenses, good-will and other intangible assets not segregated, less depreciation, ore depletion, amortization and property written off to profit & loss and to obsolescence reserve $100,228,929.97

A letter to stockholders dated April 3, 1935, stated that the only separate amounts for tangibles and intangibles which had hitherto had any actual existence were those arrived at by the Internal Revenue Department in determining taxable income. Since this department does not allow depreciation on intangibles, its natural bias is to state the tangibles at a figure as low as possible, which results in intangibles being correspondingly increased. Under this influence, the amounts arrived at for the American Smelting and Refining Company had been, for tangibles, $52,087,099.26, and for intangibles, $48,141,830.71. This then the officers decided to adopt as a basis for separation of the two classes of property; but, since the tangible property might in their judgment, which they referred to as "no more than an intelligent opinion," be reasonably valued at $100,000,000, they did not care to exhibit so disproportionate a figure for intangibles in the balance sheet. This item they therefore proposed to write down from $48,141,830.71 to $4,478,390.71, accomplishing this by restatement of capital stock.

It would be difficult to make out a case for these new balance sheet figures being more informative than the old combined figure for which they were substituted; but the company officers, acting under pressure and influence from two different departments of the Federal Government, did the best they could with a difficult situation. It remains to be seen whether the Securities and Exchange Commission will regard these separate figures as being sufficiently important to warrant regarding the action of the American Smelting and Refining Company as a precedent upon which it might insist more vigorously upon separation of the two amounts. It would seem that a reasonable view might well be that the new figures thus obtained are still more arbitrary than the old, that they add nothing to an investor's understanding of the financial condition of the business, and that the matter might therefore continue to be left to the discretion of company officers, in accordance with the present regulations.

But here again the conditions surrounding old-established companies need not govern the treatment of new ones in process of setting up their accounts for the first time. With these the Commission has dealt in energetic and critical spirit, and has not permitted obviously intangible items to be reported as if they were bricks and mortar, or machinery. In the first place, a flimsy basis, arising out of stock issues or otherwise, was no more countenanced for intangible assets than for tangibles.[10] In the second place, promoters' fees for services, experimental costs, property held on lease, and organization expenses, even if reasonably valued, are not items of tangible property, but form part of the intangible category. When the transactions giving rise to these assets have occurred in the recent past, it is not possible to contend that the amounts spent on tangibles and intangibles are indistinguishable.[11]

Division of Surplus

The requirements for the balance sheet then proceed:

> All the liabilities of the issuer in such detail and such form as the Commission shall prescribe, including surplus of the issuer showing how and from what sources such surplus was created. . . .

This is clearly intended to bring about a separation of capital surplus, if any, from the earned surplus, a matter to which in many minds even more importance has been attached than to the separate property accounts, because of the relations of surplus to earnings on the one hand, and to dividends on the other. But this requirement also raises parallel historical difficulties and ends, if persisted in, in similarly arbitrary results, as appear in the property accounts. It is in general desirable that the amount of earned surplus be clearly shown and that other surplus, derived from capital transactions of various sorts, be separately stated. But we are again confronted with the fact that in many cases this has not been done, and could now be done only by a retroactive review of surplus which would involve judgments as arbitrary as those required for the separation of tangible and intangible property where they have long been joined. Here again the Commission took a practical view of the case; it called for schedules which broke down surplus into its constituent parts, but then added:[12]

> . . . however if, in the accounts of the registrant, separate balances for these are not shown at the beginning of the period of report, i. e. if the company has not, up to the opening of the third fiscal year prior to the last annual closing date, differentiated in its accounting for surplus as indicated above in (a) and/or (b) and (c), then the registrant may state the surplus in one amount.

[10] *In re* Haddam Distillers Corp., 1 S. E. C. 37 (1934); *In re* American Gyro Co., 1 S. E. C. 83 (1935); *In re* Franco Mining Corp., 1 S. E. C. 285 (1936); *In re* Great Dyke Gold Mines, Inc., Securities Act Release No. 954, Aug. 5, 1936.

[11] *In re* Unity Gold Corp., 1 S. E. C. 25 (1934); *In re* Haddam Distillers Corp., 1 S. E. C. 37 (1934).

[12] Instruction Book for Form A-2, Balance Sheet Instructions, Surplus.

The legal advisers of corporations have been even more reluctant than the accounting advisers to undertake these arbitrary breakdowns, and to present the resulting figures as true statements of material facts. Since any such amounts could at best be based upon opinion applied to transactions and conditions which took place years ago, and have since been largely superseded by more recent events, lawyers were quite strongly opposed to their inclusion in registration statements, regarding them as vulnerable to suitors of malicious character.

Since it is a new idea to many people that there should be any difficulty in separating earned from capital surplus, it is worth while to point out precisely wherein the obstacles lie, as illustrated by the history and character of capital surplus. In the first place, a purely balance sheet conception of surplus makes no distinction between different kinds of surplus; surplus in this sense is the excess of assets over liabilities plus stated capital, no matter what its source. This definition of surplus derives a good deal of force from legal recognition, as well as some business and financial convenience. Only when one comes to study the modern income statement, yielding a figure of earnings as now strictly construed, does it become important to distinguish sources of surplus other than earnings so derived. The issue of capital stock at a premium, the sale of treasury stock for more than it cost, and restatements of capital stock which reduce the stated amount thereof and leave a balance to be transferred to surplus are all clear-cut cases of the creation of capital surplus, and proper accounting requires that they be so stated. When such transactions occur in future, there should be no question about their treatment.

But assume that a corporation had such transactions years ago and included the resulting credit balances in a general surplus account. If that surplus account had never since been touched, it would now be possible to separate these amounts of capital surplus wrongly added to general surplus. But if, as is altogether likely, dividends have since been paid and charged against the combined surplus, or other amounts have been so charged, in what proportions is it to be assumed that they were charged respectively against earned surplus and capital surplus, and in what proportions are the separate remaining balances supposed to be? This is the question to which only an arbitrary answer can be given.

The problem is still more difficult with capital surplus derived from the other principal source, namely, upward restatements of asset values. If such surplus has been combined with earned surplus, the same difficulty appears in apportioning subsequent charges against the general surplus; but a further and still more disconcerting difficulty arises, namely, the question whether the write-up really was, in whole or in part, an item of capital surplus. It is easily conceivable that a plant might formerly have been excessively depreciated, and its earnings and earned surplus thereby understated; an appraisal increasing the net book value of the assets would then be simply a correction of this situation and thus be properly a credit to earned surplus, thereby restoring it to the amount which it should have been. As a

matter of fact, many appraisals do contain some element of this kind, but how much is again a matter of arbitrary judgment.

It is a natural proposal that in such cases the old general surplus shall be carried forward, and that hereafter there shall be a separation of capital and earned surplus. But this would result in three surplus categories, and again the question arises as to how subsequent dividends and other surplus charges shall be apportioned among them. Reflection upon this difficulty is usually sufficient to deter any experienced person from seriously proposing this course; an arbitrary division is more practicable.

Consolidated Statements

Another series of problems calling for the serious consideration of the Commission was that arising from the common practice of issuing consolidated statements. Throughout the development period of our great corporations it has been felt that certain legal advantages, as well as considerable managerial and administrative conveniences, might often be secured by having the different operating units separately incorporated. While tax considerations have been a factor in determining the precise legal forms—in most cases the perfectly proper desire to avoid multiple taxation by different states, yet the managerial advantages have been a still more potent reason. Where the entire group of corporations constitutes practically a single unified business, of which the member corporations are but branches, it is universally recognized that the consolidated balance sheet and consolidated income statement are the appropriate vehicles for describing its financial condition and earnings. But recent legislative changes have had the effect of placing heavy additional burdens on such consolidations and have caused many corporate managements to review the question of the advantages to be derived from separate incorporation of operating units; if the present trend continues, it seems likely that many hitherto separate legal entities will be merged. While the regulations of the Securities and Exchange Commission have not perhaps been the greatest influence in this direction, yet they have been contributory. The essential thesis of the Commission has been that, in so far as any of these component corporations are separate legal entities with their own individual financial and legal obligations, the consolidated statements should not be used in such manner as to conceal important elements in the financial condition of any one of them. The Commission's regulations have therefore been designed to bring out the financial condition both of the issuer of new securities and also of the consolidation of which it might be a part. If, therefore, the issuer is a parent company or a subsidiary, its own corporate statements will be accompanied by the still more informative consolidated statements; the regulations prescribe what is required in respect of them, and it is specified that the basis on which the common intercorporate relations have been accounted for must be stated. These include the handling of intercompany sales, intercompany profits, and the disposition of the difference between net book values of subsidiaries and the amounts at which they are carried in the parent books; the accounting practices of the parent

in the matter of accruing in its own books the earnings or losses of subsidiaries, intercompany dividends, and the treatment of a subsidiary's initial surplus at the time of acquisition are also matters which must be explained.

An example illustrating the Commission's policy with respect to consolidation is found in the *Baldwin Locomotive* case,[13] in which the Commission criticized the company's procedure with respect to its consolidated balance sheet. Following upon the omission by the company of its interest payments on bonds in the sinking fund, and the subsequent collapse of the market prices of its bonds, the Commission held an investigation into the circumstances preceding this event, and inquired in particular into the question whether it had been in any way foreshadowed in the company's financial statements. It transpired that the very satisfactory current position of one subsidiary had, in the consolidated balance sheet, the effect of concealing the fact that the parent company's current position had been somewhat impaired. The Commission's comment was to the effect that, since the resources of the subsidiary were not available to the parent except in so far as dividends might be declared, it was a mistake to convey the impression that those resources were in fact available for the bondholders of the parent, and that the situation called for a parent balance sheet in addition to the consolidated balance sheet. The company doubtless felt that it had complied with the rules of public reporting, at any rate as they had been commonly practiced up to that time. When the standards of conduct are in process of being raised, somebody always becomes the first victim of the change in the rules.

Problems Arising from Judgment Element in Accounting

Having thus reasonably dealt with the problems of inherited conditions in the historical sections of the balance sheet, the Commission turned to those aspects of accounting, often too little appreciated, in which judgment must necessarily play a large part. In very broad terms, these problems consist mainly in the determination of the amounts which may from time to time be carried as assets in the balance sheet, and at what points they become proper and necessary charges against income. Thus the all-important question of income determination is conditioned to a marked degree by intelligent and honest judgment, requiring an extensive knowledge of general business conditions in that area, and of the effects on the financial policies of the corporation of one accounting practice as compared with another. For any government agency to enter this field with rigid prescriptions is to intrude unduly upon the management of the corporation itself, and can have only the results of the proverbial bull in the china shop. Who can prescribe a depreciation policy for a corporation, without knowing its practices with respect to maintenance, and its risks of obsolescence? Or who can determine an inventory valuation policy without an understanding of the conditions of raw material supply, cost accounting practices, and marketing problems of the particular company?

[13] Securities Exchange Act Release No. 167, April 11, 1935.

Disclosure Prescribed—Not Method

A careful examination of the present accounting requirements under the act, as embodied in Form A-2 and the accompanying instruction book, will reflect two basic principles which the Securities and Exchange Commission has adopted, to the relief and satisfaction of registering companies, and at the same time to the increase in effectiveness of the work of the Commission. The first of these principles was that the Commission would not seek to dictate the accounting practices of business corporations in all those matters in which differences of personal opinion and differences of circumstances have shown that optional treatments are permissible and necessary. Acting upon this principle, the Commission has in its accounting regulations not sought to prescribe accounting methods, but has prescribed full disclosure of whatever accounting methods the company had chosen to adopt. The detailed instructions for nearly every item of the balance sheet and income statement contain either optional treatments, or else a requirement for the statement of whatever basis the company has acted upon; examples are so numerous as not to call for citation. Sometimes, while still allowing room for discretion, the regulations state or imply the Commission's preference, such as: "If reacquired stock (treasury stock) is shown as an asset in the balance sheet, give the reasons therefor and. . . ."[14] Under Capital Stock appears: "Reacquired stock (treasury stock) is preferably to be shown as a deduction from capital stock. . . ." The general character of the regulations is much colored by the provision: "The registrant may file statements and schedules in such form, order and using such generally accepted terminology as will best indicate their significance and character in the light of the instructions."[15]

The second principle followed was that the Commission endeavored to relate its accounting requirements to the general accounting practices of business corporations, so far as these could be ascertained and generalized. Probably the chief respect in which the older accounting requirements of Form A-1 constituted an unwarranted burden on business was that at too many points they took too little cognizance of the steps by which accounting information is in practice ordinarily classified and accumulated for the company's own purposes. Questions were asked in a few words, with simple and ingenuous air, which ran crosswise of the customary processes of accounting compilation, with the result that they could not be answered from figures available in the company's books, but imposed new and additional accounting classifications and summaries. Nor is it to be supposed that these new accumulations of data, hitherto ungathered by the corporations, represented additional and valuable financial information which had been overlooked; on the contrary, they resulted in material which either was of very little value, or which, when it had value, might be much more usefully presented in the form which had already been customary, and which the accounting records of the company had been designed to furnish. After the original alarm created by the insistence on civil and criminal

[14] Instruction Book for Form A-2, Balance Sheet Instructions, Investments.

[15] *Id.*, General Requirements for All [Financial] Statements.

liabilities of issuers and their advisers, undoubtedly the next greatest concern was felt in connection with the new internal accounting burdens thus imposed. The new Commission's announcements at the time of the release of its accounting regulations intimated that it had consulted corporation officials and public accountants extensively, and the improvements in the accounting requirements in this respect reflected the substantial advantage which had thus been reaped. Corporation accounting officers have not omitted to express their appreciation of the discretion thus left to them.

Auditors' Certificates

The exercise of judgment is a conspicuous element in the certificate in which the public accountant who has reviewed the corporation's statements expresses his opinion of them. The functions of the outside auditor have not been too clear in the public mind; ideas about the detection of fraud and peculation have overshadowed the far more important constructive purpose of the presentation of a clear and reliable picture of a company's financial condition. The auditor's certificate is primarily an evidence that an independent mind has reviewed the company's statements and has concurred in the representations there made, or has dissented as explained.

There was at first some disposition on the part of the Commission to specify a form of certificate for the use of public accountants, and support for this course seemed to be implied in the adoption by the Committee of the American Institute of Accountants on Cooperation with Stock Exchanges of a form of certificate[16] for recommendation to the notice of auditors of companies listed on exchanges. But it was pointed out that it was one thing for the public accounting profession to discuss and recommend desirable practices, and something quite other for a government body to prescribe those practices with statutory force, and thus in part inhibit the use of that very judgment the public accountant was supposed to contribute. The view prevailed that the public would be served with more helpful opinion if the auditor were left to express himself in his own way, and that since he was to be held liable for what he said, it was not quite reasonable to put the words in his mouth. But the matter was not left entirely open; the Commission outlined the subject matter to be covered in the certificate, and insisted that the auditor's opinion should be candid and complete.

The chief debatable ground between the Commission and the public accounting profession lies in the question: Granting that the public accountant's function is to furnish his opinion, how far should he go? In particular, how far should he go in criticizing the company's presentation? It is perhaps a natural view to suppose that the more criticism is supplied, the more light will rest upon the subject; but that is another maxim that does not work out as it appears. The ideal is the certificate without qualification, meaning that all the points which have come up for

[16] Reproduced in EXAMINATION OF FINANCIAL STATEMENTS (Am. Inst. of Accountants, 1936) 41.

discussion during the examination have been settled to the mutual satisfaction of the company officers and the auditors. A balance sheet and an income statement are thereby offered to the public which, in the joint opinion of both, are the clearest and most helpful statements that can be presented. As soon as qualifications by the auditor appear the outside reader is left somewhat in the position of arbiter with very little to go upon in arriving at a judgment between the two. While, therefore, it is the auditor's duty to report any matter of moment in which he may wish to qualify the company statements, he will prefer to refrain from clouding the picture with disputation about less important matters. In drawing the line he can but fall back upon his own judgment, aided by the Commission's definition of a material fact.[17]

Commission Influence on Accounting Statements

What influences have been exerted by the regulations and by their subsequent administration? There can be little doubt that they have gone a considerable distance in fulfilling the purposes of the act in developing a more faithful and complete reporting of financial condition. In so far as there were cases where promoters and others were disposed to be something less than conscientious in the preparation of statements, the regulations have added a little stiffening to their consciences; and where accountants have sought to do their full duty as faithful witnesses, the regulations have made them more effective in standing up against those influences which, innocently or not, have tended to color, exaggerate, or suppress. In other words, they have undoubtedly been brought a step or two nearer the fulfillment of their functions as accurate and impartial reporters of the truth about corporate financial condition, which must, however, be read in the light of what has elsewhere been said about the inescapably relative character of such truth. But three things at any rate may be pointed to as examples of the effects of the regulations, in addition to the raising of the general level induced by the complete specification for public reporting which the regulations as a whole constitute. The first of these arises in the balance sheet; the second relates to property valuations in the balance sheet; and the third concerns the income statement.

Changes between Balance Sheets

In any balance sheet filed with the Commission, the regulations are designed to bring out all important factors, and not leave significant items concealed by combination, offset, or inadequate description. Still more, since it is commonly recognized that the changes between balance sheets are frequently of more significance than the items in a single balance sheet, the more important of those changes are analyzed by means of the schedules required to be attached to the balance sheet. The net changes, of course, were always available to any person who compared two succeeding balance sheets, but, by requiring both additions to and subtractions from

[17] Instruction Book for Form A-2, Definitions.

the beginning balances, the full character and extent of the changes is brought to light. These schedules relate to the property and plant items, to the intangible items, to investments in marketable securities and for control, and to surplus. Not only do they bring to light the extent of the changes in these items, and any unusual transactions connected with them, but also, in so doing, they supply further information about company policies on such things as maintenance, and provide more information than has hitherto been available on cash requirements for plant purposes. In other words, they add to the picture of what some call the dynamics of the business. Here again it is fair to say that in so far as this information has been significant it has already been furnished by the larger and better reporting corporations, either as footnotes to the balance sheet, in appended schedules, or in the president's narrative report. The effect of the regulations is to make this practice general for all who come within the operation of the Securities Act.

Income Statement Developments

In recent years the importance of the income statement has been increasingly recognized, and, by requiring a more extensive income statement than has hitherto been generally available, the Commission has sought to insure that reported earnings shall be arrived at as soundly as possible. Opening with the amount of gross sales, followed by the cost of goods sold, the regulations require that a number of items in which public interest is considerable shall be separately set forth, either in the income statement or in Schedule VIII, or in both. The schedule is designed, moreover, to give flexibility to the situation so as to comport with whatever accounting practices the company may have followed. There is, for example, greatly varying practice as to whether the items of depreciation, maintenance, interest, insurance, and rents and royalties are included in cost of goods sold, or stated later as financial deductions, or charged in part to selling and administrative expenses. Schedule VIII is designed to accommodate itself to any or all of these different conditions. Income from sources other than operations, and non-recurring income, together with the corresponding expenses, are required to be separately stated, as called for in the law.[18] The net result is that it would take something of daring and deliberate misrepresentation to conceal any important feature of the earning statement, or make it look materially different from what it should be.

The tendency to greater exactitude in the statement of income is illustrated in the prospectus issued by Shell Union Oil Corporation, dated March 10, 1936, in which a change of accounting practice was announced. Certain amounts arising from retirement of debentures, which had been charged or credited to income account in the published annual reports, were in the prospectus shown as surplus charges or credits. The same type of thing appears in the prospectus of Jones & Laughlin Steel Corporation, dated April 2, 1936; though in this case a change of auditors may have had something to do with the change in accounting practice, it

[18] Securities Act, Sched. A, par. 26.

is reasonable to suppose that the Commission regulations were the greater influence. Probably investment trusts also will be more generally disposed than hitherto to keep their income accounts free of capital or non-recurring gains and losses.

This question of the line to be drawn between the income account and surplus will of course be a perpetual one. It is to be hoped that the Commission will stick to its requirements of full disclosure of all unusual surplus charges and credits, but again it will do well not to lay down too rigid rules. In the first place, no rule can be satisfactory in all cases; in the second place, there is something to be learned about a company and its management from the kind of accounting they do when left to themselves, provided their accounting can be clearly seen. This is especially true of a practice like the base stock inventory method, which implies a conservative and long-range view of income determination, and of charges to surplus rather than to income, which tend to imply the reverse.

Property Accounts in Commission Decisions

Property and plant valuations have received a good deal of attention in the Commission's decisions and opinions,[19] and, while the Commission has shown itself disposed to give reasonable weight to accounting opinion and authority, it has not been willing to acquiesce in extravagant valuations based chiefly on legal technicalities connected with stock issues, and having little of substance about them. The predilection of promoters for issuing stock in round sums, and then valuing property at any amount required to balance, has been discouraged in the most vigorous terms, and so have the more fanciful speculations of appraisers. Disclosure of the basis of property values has been insisted upon, and properties "at cost" have been required to show substantial consideration, so that stock selling in cash transactions at a nominal amount per share has not been admitted at much more substantial sums as a basis for property values.[20] While recognizing that many aspects of accounting call for reasonable judgment, the Commission has rejected the idea that reasonable judgment includes the suppression of known facts;[21] and, if in the exercise of judgment such items as the costs of planning, surveys, taxes, insurance, permits, engineering fees, interest, and specifications have been included in the cost of a building, then the reasonable consequences of this decision must be faced, and these charges depreciated together with the building.[22] Even when property has been stated "at cost," a much higher appraisal figure, tending to imply that the cost valuation was conservative, was not admitted when the appraisal itself turned out to be questionable.[23] Appraisals of water supplies based upon alternative sources of water, when nobody would in fact think of using those alternative sources, and when the actual cash outlays were only a small fraction of such appraisals, have been

[19] See Volume I of the Decisions of the Securities and Exchange Commission and subsequent releases.
[20] *In re* Unity Gold Corp., 1 S. E. C. 25 (1934).
[21] *In re* Big Wedge Gold Mining Co., 1 S. E. C. 98 (1935).
[22] *In re* Continental Distillers and Importers Corp., 1 S. E. C. 54 (1935).
[23] *Ibid.*

rejected.[24] In the field of mining engineering it has not been regarded as a proper exercise of judgment to base valuations on extravagantly optimistic estimates, while suppressing all mention of other (and apparently more accurate) tests which indicated very little value in the property.[25] In many of these cases promoters figured as simultaneous buyers and sellers of property, a situation always provocative of doubts, and the Commission has examined them with candor and penetration.

Criticisms of the Commission's Accounting Policies

Criticism of the accounting requirements of the Commission has taken four main lines: first, that while the printed regulations are in general broad and reasonable, the administration of those regulations by the Commission's staff is less so and in some instances descends to trivialities; second, that while the information thus elicited may be of value, even of considerable value, this is not sufficient to justify the great cost and burden of producing it; third, that some of the information required is of confidential character, and should not be publicly disclosed by the Commission; fourth, that these things are better left to work themselves out, without the intervention of the government. These objections will, therefore, be considered in order.

Administration by Federal Trade Commission

It is not necessary here to discuss the accounting phases of the somewhat abortive administration of the act, before it was amended, by the Federal Trade Commission. Whether the act itself stopped the flow of new issues, or whether the stoppage was solely the result of the depression; whether the burden and expense of preparation of registration statements really were prohibitive, or whether corporation officials and their legal and accounting advisers were swayed by baseless fears and magnified their own difficulties, are questions which as a practical matter it is unnecessary to answer now. Undoubtedly something of all these elements was present. The fact that the act was amended is admission by its sponsors that the original requirements were unduly severe. As to the preparation of registration statements, it is unquestionably true that the few which were prepared before the transfer of administration to the Securities and Exchange Commission were prohibitive in financial cost, and still more so in respect of the human effort which went into them. It would have been quite impossible to do any considerable amount of business on such a basis.

Administration by S. E. C. Staff

There is probably some truth in the charge that the Commission's staff is less flexible than the Commission itself might wish; this is a result almost inseparable from any large administrative task, since juniors cannot be granted, nor are they willing to assume, as much discretion as their seniors would probably use. Cases are cited in which valuable time is consumed upon trivial details, and although such

[24] *In re* Haddam Distillers Corp., 1 S. E. C. 37 (1934).
[25] *In re* Big Wedge Gold Mining Co., 1 S. E. C. 98 (1935).

insistence is exasperating, it is less important than its almost inevitable accompaniment that the staff may overlook more significant matters. As a matter of fact, while the Commission states that its accounting requirements constitute a minimum of information to be supplied by registrants, in a very real sense they also establish a maximum of demands which the Commission may make upon business.

Of much more moment are the implications of an announcement such as:

"Allis-Chalmers Manufacturing Company will be asked by the SEC to amend the financial reports submitted in its permanent registration application early this year to conform with the reports filed under the Securities Act registration last week."[26]

It may be presumed that the "permanent registration application" was Form 10 under the Securities Exchange Act. In the accountants' certificate included in the prospectus issued by this company on November 6, 1935, it was stated that certain adjustments, enumerated and explained, had been made in the profit and loss statements there given, which therefore differed "from the net results shown in the registrant's annual reports to its stockholders heretofore published." The description develops that these adjustments consisted of redistributions of amounts as between individual years from 1931 to 1934, but did not affect surplus at December 31, 1934. Presumably the statements incorporated in Form 10 were similar to those published in the company's annual reports, but under the more exacting requirements of the Securities Act the period had been reviewed and these adjustments made in Form A-2. It will frequently happen that any review of a series of years will in the light of results develop adjustments of this character, and these adjustments, especially when they affect profit and loss, may have some bearing on the value of a new issue, even though the aggregate result for all years is the same as before. The Commission is entitled, and indeed obligated, to require an explanation of these adjustments. But as regards the annual reports to stockholders, that for December 31, 1935, announced the adjustments in terms practically identical with those of the prospectus, after which there was no occasion to attempt to restate the annual reports already issued. Apparently, therefore, the only question raised was whether it was sufficient for Form 10 to give the annual statements as furnished to stockholders or whether it should contain the same adjustments as shown in Form A-2.

This question of restatement of financial reports already published came before the Commission in the case of *Northern States Power Company*,[27] in which the Commission voted three to two to accept certain explanations as to the treatment of bond discount in past statements, without requiring restatement of the past balance sheets, earnings, and surplus accounts. The Commission should continue to resist this tendency to require restatement of accounts which have already entered into

[26] *Wall Street Journal*, Oct. 23, 1935.
[27] Securities Act Release No. 254, Nov. 21, 1934.

the public record. The Allis-Chalmers adjustments were far less serious than those in *Northern States Power;* the former were probably such as could be determined only from review after the event, while the latter contained features which could scarcely have been regarded as other than questionable accounting at the time they occurred.

The important point is that it is far more illuminating to let the record stand, and state plainly wherein it was at fault or subject to modification, than it is to attempt restatement of the original record. The latter procedure can only result in endless confusion; it is time-consuming and expensive, and the results are less helpful to investors than those of the former course.

On the other hand, it seems to be the Commission's policy to adapt its procedures to the exigencies of particular cases. This is shown in its practice of bringing out special forms for special industries, in order to deal effectively with them and yet avoid burdening other industries with requirements with which they are not concerned. In this way the Commission will tend to maintain a greater flexibility in its administration.

The burden of preparation of registration statements and prospectuses is still considerable, but much less than it used to be. The preparation by old-established companies of registration statements on Form A-2 has largely settled down into a routine; company officials and accountants know what is expected of them and have adapted their accounting practices to the requirements. In the space of three years the transition has been made from a condition in which the preparation of a registration statement was an agonizing procedure to one in which it has become a normal event taken more or less in stride. The schedules attached to the balance sheet and income statement are apparently the feature most complained of on this score. They frequently involve extra work, over and above what would be undertaken but for the Commission's requirements, and are especially arduous for large consolidations. An alternative, as regards the plant schedules, would be for the information to be furnished in narrative instead of tabular form and to give only the substance of the changes. In the form of narrative such information has been regularly furnished by a number of companies in their annual statements; but the account analysis in tabular form is more formidable to readers. Doubtless the Commission's viewpoint is that it desires a complete accounting between the beginning and the end of the period, but this is one place in which there is an opportunity to do something both to reduce the burden of work and also to present the information in more usable form. It should be possible to do this with proper safeguards that nothing important will be omitted. But mention of the point is indicative of the scarcity of criticism of the requirements from the point of view of the burden they impose.

Confidential Information

The Securities Exchange Act authorizes the Commission[28] to hold confidential any information which, upon application of the registering company, the Commission shall consider to be deserving of such treatment, provided it can be done without injury to the public interest; notice of this was accordingly inserted in Form 10. The anxieties of issuers have been aroused most by the requirements that they state the amounts of sales and cost of goods sold on the one hand, and salaries of officials on the other; the most common requests for confidential treatment have therefore been concerned with these items. At first no such provision was contained in Form A-2, but an amendment[29] provided that any company which had been accorded confidential treatment under the Securities Exchange Act for the items Sales and Cost of Goods Sold might omit those items in Form A-2.

The chief source of fear arising from the publication of sales, cost of goods sold, and gross margin has been that powerful competitors or powerful customers might use the information to the injury of the company. It has frequently been argued that the showing of a too prosperous-looking gross margin would attract unwelcome competition to the field. The argument gains additional force where the company manufactures only one main line of goods, with which the gross margin can be identified; if a heterogeneous line of goods is manufactured and sold, the information as to gross margin is less informative to an outsider.

The detached and unbiased person will find some difficulty in coming to a conclusion on this subject satisfactory to his own judgment. He is bound to have some sympathy with the anxieties of business men who feel that they are being placed in a more exposed position than ever before and that the information sought as a protection to their stockholders is in fact a menace to them; it is not a satisfactory solution merely to make light of their difficulties. That the Commission has lent a sympathetic ear is clear from the fact that during the year ended June 30, 1936, it has granted confidential treatment to 214 items of information filed by 162 issuers; applications were received from 631 issuers for confidential treatment of 966 items. These would all be under the Exchange Act. But a careful consideration of numbers of cases in which this treatment has been claimed leads to the conclusion that, from the public point of view, the requirement for disclosure is in general a reasonable one, and that the Commission has done well to insist upon it as part of the income statement. It is true that the sales figure alone is of little value to those studying the company's position, but the same might be said of almost any single figure in the balance sheet or income statement, with the possible exception of the net profit figure itself. Practically all individual items are merely contributory to the general impression which it is sought to obtain. Security analysts claim that they make much use of the comparative sales from year to year, especially in computing the proportion of increased sales which comes through as net profit. This is the

[28] Securities Act, §24(b).
[29] Securities Act Release No. 930, July 30, 1936.

sort of information which has sometimes been characterized as being more useful to speculators than to investors. The Commission may well continue to accord confidential treatment in those cases in which the circumstances seem to justify it; there undoubtedly are instances in which disclosure would do more harm than good.

Public Policy

The most fundamental objections to the accounting requirements are of course those arising from a political philosophy at variance with that upon which the act is predicated. Those who hold that it is none of government's business to intervene in these matters and that investors will learn faster from getting their fingers burned than from spoon-feeding with even the most reliable information will necessarily have difficulty in accepting the machinery of the act. There is more to be said for this viewpoint than is commonly supposed; but as a practical matter everybody recognizes that the question is one of degree, that in the present mood of the people government cannot abdicate the office of umpire, that what seem like extensions of government function are in part government's attempts to keep pace with the increasing complexity of economic life, and that the problem consists in keeping all these forces in as just a balance as possible. Responsible accounting opinion has almost everywhere approved the fundamental conceptions of the Securities Act, but has bent its effort in the direction of making its provisions more effective by keeping them within temperate bounds.

Utilization of Information by Investors

The extent to which the financial information elicited by the Commission is utilized by investors and its value to them are matters on which there is much dispute. The benefits accrue largely by indirect and imperceptible process, which does not permit any close relating of investment action with specific disclosures. Information developed under Form A-2, concerned as it usually is with old-established corporations, does not as a rule add anything of great moment to the information already available on the same companies. From financial statements previously published, intelligent investors are already apprised of the company's record of earnings over a period of years, of its current position and general financial strength; they have formed fairly definite impressions of the capacity of the management, of the future prospects of the company, and of the industry to which it belongs. Sound investment opinion is a plant of slow growth; it cannot be created *instanter,* and draws support from all sorts of sources outside the limits even of Form A-2. From such considerations it is easy to argue that registration statements have as yet added very little to the sum of essential investment information.

With newer and more hazardous promotions, on the other hand, the registration statement and prospectus prepared under the Commission's rules undoubtedly furnish more, and more reliable, information, than has commonly been hitherto available. But the buyers of such securities notoriously do not act upon careful analysis;

they act upon hunches, the tips of friends, the specious representations of salesmen, all sorts of motives except deliberate consideration of sound information. In so far as they may be disposed to do a little serious analysis, however, they are being provided with far more information, of a far more genuine stamp, than they have had before, and it is reasonable to suppose that this is likely at least to induce in promoters a greater sense of responsibility, even if the more gullible kind of investor seldom reads their frank revelations.

Among those responsible for the dissemination of financial information, some disappointment is expressed with the degree of interest with which the additional material has been received. It is asserted that too many investors are content to observe and follow the trends; that the generally upward trends since the passage of the Securities Act in 1933 have been the basis of security buying; and that individual security analysis has been proportionately less searching. There can be no doubt that there is much tendency in the direction stated.

Liabilities for Accounting Information

Consideration of the accounting problems involved in the public reporting of company financial condition and earnings induces reflection upon the liabilities imposed upon issuers and accountants with regard to financial statements. How far do the liabilities now attaching to the makers of financial statements coincide with the responsibilities which they may reasonably be expected to carry, and what policies with respect to them does the public good seem to demand?

A free flow of capital into business, both for developing new industries and for expanding old ones, is eminently in the public interest. It is no denial of this fact that speculation sometimes becomes unreasonable and disastrous, but such occurrences point to the need for some form of regulation.

It is inevitable that many ventures will not turn out to be financially successful. Public policy cannot therefore undertake to guarantee a happy outcome for all investments, but should tend to encourage discrimination among investors as to the types of security they buy. In particular, small investors should be encouraged to commit their savings to places subject to some form of public supervision, including the various categories of government bonds, insurance of all kinds, and savings banks.

In so far as the public does invest in industrial securities it is desirable that the issuers should furnish such information as will enable the character of the securities to be judged with some degree of assurance and that there should be a government agency to see that this be done.

But the general tendency to regard financial statements as statements of absolute fact should be recognized as being itself somewhat delusive, and regulation should seek to adjust the balance by taking cognizance of, and seeking to make more widely

understood, the extent to which accounting statements are matters of fact on the one hand and matters of opinion and judgment on the other.

The Commission advances the definition of these problems when it reserves its condemnation for such things as the showing in financial statements of "values beyond any maximum that differences of opinion might condone."[30]

The liabilities of issuers have not only been increased by the Securities Act, but have also been widely advertised by public discussion. It is generally apprehended that when the next great collapse in security prices occurs, many suits to recover losses will be brought by disappointed losers. It will then be necessary that the courts, to do justice in individual cases and to further the wisest public policy, should give full consideration to:

a. The essential character of financial statements, especially the extent to which they are respectively matters of fact or matters of opinion and judgment.

b. The natural tendency to make *ex post facto* judgments and to read into statements interpretations which could not have been formed at the time the statements were prepared.

c. The tendency of juries to sympathize with losers, especially with losers at the hands of corporate finance.

The areas within which controversy will arise will include:

a. Actual facts stated in the balance sheet and income account. On these, for the most part, responsible company officers and their accounting advisers will, with ordinary care, be able to furnish information to the reasonable satisfaction of the public and without too much risk for themselves.

b. Omissions of material facts. The definition of material facts can never be specific and exhaustive; references in some prospectuses to possibilities of inflation, foreign invasion, or other political disturbance suggest the range of conjecture. The courts will be confronted with the problem of determining how far the event might reasonably have been expected to be foreseen at the time of issue and to what extent it was culpable negligence to omit mention of the fact, if foreseen.

c. Matters in balance sheets and income statements which call for the exercise of judgment and on which a plaintiff, prompted perhaps by subsequent events, has placed an interpretation differing from that embodied in the statements.

d. Admitted misstatements of financial fact, about which the large question then is whether, and to what extent, they caused the plaintiff's loss.

Unless the law gives full weight to the foregoing considerations, it will be inevitable that forces tending the other way will bring about serious miscarriages of justice.

It is not desirable that accountants should, in pointing out these problems, go the

[30] *In re* Haddam Distillers Corp., 1 S. E. C. 37, 46 (1934).

length of minimizing the important part which financial statements play in investment activities. They constitute essential elements in the structure of information upon which judgments are formed, first by the underwriters, and second by large investors and statistical agencies who also examine with care the information furnished.

Three questions arise, with reference to financial statements alleged to be misleading: (1) whether there is liability or not; (2) to whom there is liability; (3) the amount of the liability.

1. When the defence is allowed that those who prepared the statements (a) had made reasonable investigation, (b) had reasonable grounds to believe, and (c) did in fact believe that the statements made were true and complete, it does not seem that the burden of proof here imposed upon defendants is unduly heavy.

2. For issuers and accountants to deny any responsibility to the considerable army of investors who act not directly on their own knowledge and judgment but on the judgments of intermediaries in whom they have placed confidence seems out of step with the general trend of the law, which is disposed to hold a producer responsible to his ultimate customer through all the increasing complexities of distribution.

For this reason there is force in the view that an issuer owes some responsibility to a purchaser, even without direct knowledge of or reliance by the latter on the statements alleged to be untrue or omitted. It seems likely that accountants will enhance their own influence and prestige if they consent to this view, as some of them already do.

But clearly there must be limits. In particular the distinction must be seen between a tangible commodity like a can of food, and an intangible thing like information. The can of food in itself has obvious limitations; it can be definitely identified with its source; it maintains its physical integrity from producer to consumer; it was plainly intended to be eaten by an ultimate consumer, no matter how many intermediaries handled it on the way, and probably it can poison only one family. But information is a more elusive and expansive article; as soon as we get away from the original statements, and begin tracing their "influence," there is no end to the garbling that can ensue, no possibility of identifying the information ultimately consumed with that which the statements first put into circulation, and no limit to the number of people who can claim they were misled by it.

Granting therefore that the makers of financial statements should recognize an obligation to those who may directly or indirectly act upon their statements, the law must find some means of keeping this within reasonable limits.

3. As for the amount of the liability, it is not reasonable to hold issuers and accounts responsible for every interpretation that purchasers may put upon their statements. They are somewhat in the position of Dr. Johnson when he said, "I have found you an argument; I am not obliged to find you an understanding."[31]

[31] 8 BOSWELL'S LIFE OF JOHNSON, c. IX.

Accountants are bound to provide financial statements as informative and helpful as possible, but they are not bound to furnish the ability for the complex task of understanding them.

As to whether the misstatement or omission caused the loss, so many other forces can and will operate to bring disaster to an individual company that it is unlikely that the misstatement or omission of any one material fact can be solely responsible for the ultimate outcome of an investment. From this it seems clear that the law bears too heavily on issuers and accountants when it seeks to levy the entire loss upon them, and still more when it seeks to place upon them the burden of proof that the loss was not attributable to the statements complained of.

The use of the phrase "any competent court of jurisdiction" as the authorized place for suit seems unfortunate in matters of this character. If this jurisdiction were restricted to federal courts there would be more probability of the development of a homogeneous treatment of these complex accounting problems, instead of the confusing contradictions likely to result from their handling by the state courts.

THE SECURITIES ACT AND CORPORATE REORGANIZATIONS

ABE FORTAS*

In 1934, Congress directed the Securities and Exchange Commission to make an investigation of reorganization and protective committees and to report the result of its study and its recommendations.[1] The Securities Act of 1933 was not designed to provide controls over corporate reorganizations.[2] Comparatively few reorganizations are subjected to the regulatory provisions of the Act, and no specialized treatment is provided for even these cases. Moreover, observation of the current cycle of reorganizations and the detailed investigations made by the Commission, pursuant to Congressional direction, have shown that adequate controls over reorganizations do not elsewhere exist—that controls are necessary and that existing regulatory machinery is inadequate.[3] It is, therefore, timely and important to canvass the theory and operation of existing controls so that new machinery may be devised which will be effective for the purpose of inducing reorganizations which are fair and economically sound.

It is likely that most reorganizations are to some extent affected by statutory or judicial controls. It is probable that only a small percentage of changes in the rights of existing security holders is accomplished by purely consentual machinery.[4] In a few states, even the alteration of preferential rights is affected by statute designed to give to dissident security holders the right of appraisal as an alternative to acceptance

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Nothing in this article may properly be taken as an expression of opinion of the Securities and Exchange Commission or of the Protective Committee Study of that Commission.

[1] Securities Exchange Act, §211.

[2] The term "reorganizations" is used in this article in its broadest sense, to include capital readjustments, debt rearrangements, merger, consolidation and sale of assets as well as reorganizations in receivership or bankruptcy or by means of foreclosure.

[3] See S. E. C. REPORT ON THE STUDY AND INVESTIGATION OF PROTECTIVE AND REORGANIZATION COMMITTEES (1936) Pts. III, IV, VI.

[4] Of this type are reorganizations effected by unanimous consent, which are probably rare, and changes in various provisions of securities by less than unanimous consent, pursuant to or in reliance upon provisions of charter or trust indenture. See, *e. g.*, S. E. C., *op. cit. supra* note 3, Pt. VI, pp. 143 *et seq.*, "Reorganization by Contract." To be distinguished are instances in which reorganization is effected pursuant to or by aid of statutory or judicial machinery.

of the proposed modification of security.[5] The right to appraisal is also commonly available in respect of merger, consolidation or sale of assets, the procedure for effecting these being governed by legislative enactment.[6] Even the appraisal statute, distant as it seems from control over the processes of modification of rights, unquestionably exerts some restraint upon a putative tendency of the reorganizers to seek from a class of security holders inequitable sacrifices. Such restraint is the product of fear that, unless equity is done, the number of those whose securities must be appraised and purchased will be increased.

Universal, and more elaborate than the above, are the controls which exist when a corporation undertakes to reorganize in the equity or bankruptcy courts. There the court has, generally speaking, control over the fairness of the plan and its conformity with the law of the land, and residual jurisdiction over other aspects of the reorganization.[7] A few states, moreover, have provided elaborate machinery for the regulation of the activities of protective committees.[8] Only in a limited field is anarchy complete. In jurisdictions where appraisal statutes are not applicable to alteration of preferential rights, reclassification of capital stock has taken place upon the level of supposedly free contract—without other sanction or control.[9] Complete reorganizations of debt as well as capital structure sometimes take place upon this level, with the aid of the doctrine of the *Moline Plow* case.[10] In such situations, only the jurisdiction of equity courts to enjoin fraudulent or grossly unfair action is an available restraint.[11]

It is not possible within the limited scope of this article to show that control over reorganizations is necessary, and to demonstrate that existing controls are inad-

[5] See, *e. g.*, N. Y. CONSOL. LAWS (Cahill Supp. 1931-1935) c. 60, §38; OHIO GEN. CODE (Page Supp. 1932) §8623-72. Concerning appraisal statutes generally, see Lattin, *Remedies of Dissenting Stockholders under Appraisal Statutes* (1931) 45 HARV. L. REV. 233; Weiner, *Payment of Dissenting Stockholders* (1927) 27 COL. L. REV. 547; Levy, *Rights of Dissenting Shareholders to Appraisal and Payment* (1930) 15 CORN. L. Q. 420.

[6] See, *e. g.*, N. Y. CONSOL. LAWS (Cahill Supp. 1931-1935) c. 60, §§20-21; 85-87; *id.* (Supp. 1936) c. 60, §§21, 85.

[7] The extent of this residual jurisdiction in receivership is subject to debate. Compare *Developments in the Law—77B* (1936) 49 HARV. L. REV. 1111, 1157; *In re* Republic Gas Corp., C. C. H., BANKRUPTCY SERVICE, par. 3721 (S. D. N. Y. 1935).

[8] See the California Corporation Commission, CAL. CODE (Deering, Supp. 1935) Tit. 280, and the Michigan Public Trust Commission, MICH. COMP. LAWS (Mason's Supp. 1933) §290 and especially §290-3.

[9] Proxies solicited for such purposes, in respect of securities registered on a national securities exchange, are subject to the regulations of the Commission under §14(a) of the Securities Exchange Act. See discussion *infra*. Note also the applicability of the Securities Act unless exemption is available under §3(a)(9), discussed *infra*, p. 224.

[10] Allan v. Moline Plow Co., 14 F. (2d) 912 (C. C. A. 8th, 1926). In brief, this type of reorganization is based upon usual provisions in trust indentures requiring demand by 25%, for example, of the bondholders before suit can be instituted. When the consent of 76% of the bondholders has been obtained, the reorganization can be effected, the minority having no remedy. *Cf.* S. E. C., *op. cit. supra* note 3, Pt. VI, pp. 62-63 *et passim*.

[11] See, *e. g.*, Homer v. Crown Cork & Seal Co., 155 Md. 66, 84, 85, 141 Atl. 425, 434 (1928). See also the interesting case of Wilson v. Waltham Watch Co., 293 Fed. 811 (D. Mass. 1923). The California statute purports to make the appraisal remedy exclusive of any other remedy, even though the remedy is sought upon the grounds of fraud. See CAL. CIV. CODE (Deering 1931) §369, and Ballantine, *Drafting a Modern Corporation Law* (1931) 19 CAL. L. REV. 465, 482.

equate.[12] The following discussion will be restricted, in general, to an appraisal of the effect of the Securities Act upon existing reorganization practice and to an analysis of the adequacy of the theory of disclosure to provide the desired control over reorganizations.[13]

I. SECTION 17(b) OF THE SECURITIES ACT

At the outset, it is desirable to refer to a section of the Act which is, in a sense, collateral to its principal scheme, registration of security issues. Section 17(b) makes it unlawful to give publicity to any description of a security, though the security is not thereby offered for sale, if the person publishing the description has received or will receive a consideration therefor, unless such consideration and the amount thereof are disclosed. The "tipster" who offers advice apparently unbiased, but in reality bought and paid for, has long been a hazard in reorganizations as well as in other fields of financial activity. On December 28, 1933, the Federal Trade Commission issued a release affirming the applicability of this section to reorganizations.[14] The release stated that a securities statistical service was employed to assist in preparing a plan of reorganization. The company was to receive a flat fee, not contingent upon the success of the reorganization. It proposed to recommend in its pamphlet that bondholders of the corporation being reorganized deposit their bonds under the plan. The Commission held that if the fee was contracted for with the understanding that the reorganization plan would be recommended by the company, the proposed consideration and the amount thereof would have to be disclosed.

The effect of this provision of the Act and of the Commission's opinion is evidenced by an incident developed in the course of a hearing held as part of the study of protective committees under Section 211 of the Securities Exchange Act.[15] A plan of reorganization for a public utility holding company[16] controlled by an investment banking house[17] was formulated. It was to be submitted to security holders by two protective committees formed by the investment house and its associates.[18] A prominent statistical agency[19] agreed to study the plan.[20] If the agency decided that the plan was practicable and equitable, the reorganization committee would state in its literature that the investment agency unqualifiedly recommended acceptance of the plan.[21] For this, the agency was to receive a fee of $5,000.[22] But on November 22, 1933, according to the record, the agency received a ruling from the Federal Trade Commission to the effect that the fee would have to be disclosed

[12] Reference is made to the published and forthcoming reports of the Securities and Exchange Commission to Congress under §211 of the Securities Exchange Act. See note 3, *supra*.

[13] See also Legislation Note, *Reorganization of Corporations and the Securities Act* (1934) 34 COL. L. REV. 1348; Edminster, *Security Reorganization under the Securities Act* (1933) PROC. NAT. ASS'N SECURITIES COMM'RS 145.

[14] Securities Act Release No. 97, pt. 15; C. C. H., STOCKS & BONDS SERVICE, Vol. III, par. 4764.02.

[15] Hearing before the S. E. C., In the Matter of Federal Public Service Corporation (1935), pp. 725 *et seq.*

[16] Federal Public Service Corporation.

[17] H. M. Byllesby & Co.

[18] *Op. cit. supra* note 15, at 608, 739-741, 748, 627-628, 641.

[19] Standard Statistics Company, Inc.

[20] *Op. cit. supra* note 15, at 725.

[21] *Id.*, at 727.

[22] *Id.*, at 725.

in order to avoid violating Section 17(b) of the Act.[23] Rather than make such disclosure which, presumably, would adversely affect the company's reputation for impartial investment service, it surrendered all claim to compensation. The committee was allowed to state that the agency had examined and approved the plan, but no fee was paid.[24]

This incident evidences, I believe, a clear advance in reorganization practice along the difficult road to elementary decency. Section 17(b) seems equally applicable to persons who are hired by reorganizers to solicit assents or are paid for the assents or deposits which they have procured. Undisclosed paid solicitation, sometimes by commercial banks or by brokers who occupy a position of some trust in respect of their clients, has been an obvious evil in reorganization practice.[25] Disclosure of the receipt of compensation may be awkward and embarrassing to the solicitor who in the past has seemed to urge deposit or consent because of friendship or altruism; but it is a minimum standard for fair and honest conduct.

So far as appears, then, Section 17(b) of the Securities Act, in respect of reorganizations has laid down a definite and salutary rule. But the abuse which it forbids is, after all, of minimum importance in comparison with the practices which it leaves untouched. In general, the Securities Act, so far as it affects the remaining practices in any way, does so through provisions for registration of security issues. Under other acts which it administers, the Securities and Exchange Commission exercises additional jurisdiction over reorganizations. Under the Public Utility Holding Company Act of 1935, the Commission has comprehensive control over the reorganization of registered utility holding companies.[26] Two provisions of the Securities Exchange Act of 1934 are important in reorganization. Pursuant to Sections 12(a), (b) and (c), securities (including certificates of deposit) traded on a national securities exchange, except exempted securities, must be registered.[27] Section 14(a) of the Securities Exchange Act of 1934 empowers the Commission to regulate the solicitation of proxies "in respect of any security (other than an exempted security) registered on any national securities exchange" and makes violation of the Commission's regulations unlawful.[28] Reference to the latter provision of the Exchange Act will hereafter be made in connection with various aspects of Commission regulation under the Securities Act; otherwise, both the reorganization

[23] *Id.*, at 728-729.

[24] *Id.*, at 730-731.

[25] *Cf. dicta* in S. E. C. v. Torr, 15 F. Supp. 315 (S. D. N. Y. April 10, 1936).

[26] See especially §§11(f) and 11(g).

[27] Ability to effect the listing of reorganization securities is sometimes critical to success of the reorganizers. Obviously, if certificates of deposit offered by a committee can be traded on an exchange, they are more attractive to security holders. By the same token, a committee which has not listed its certificates may find it difficult to persuade holders to exchange listed securities for unlisted certificates.

[28] See the regulations of the Commission pursuant to this section. Securities Exchange Act Release No. 378, Class A, Sept. 24, 1935, C. C. H., STOCK EXCHANGE SERVICE, pars. 5281-5285 C. These regulations, in general, require filing of a form of the proxy used and disclosure of specified types of facts. They forbid false or misleading statements of material fact in the course of solicitation. They also require the issuer or its management soliciting proxies to mail proxy and circular forms furnished by any security holder "to every record holder" solicited by the management.

provisions of the Public Utility Act and the provisions of the Securities Exchange Act are beyond the scope of this paper.[29]

II. REGISTRATION UNDER THE SECURITIES ACT—IN GENERAL

The broad plan of the Securities Act, in so far as it affects reorganizations, is to require full disclosure of material facts concerning the securities offered as an intermediate or final step in reorganization. Unless an exemption is available, the "issuer" of certificates of deposit,[30] which may be a protective committee or the reorganizing corporation, and the issuer of the securities exchanged under the reorganization plan for outstanding securities must effect registration with the Commission.[31]

Reorganization procedure is traditionally such that disclosure of information concerning the securities issued in exchange under the reorganization plan is generally of secondary importance to the investor whose securities are involved in the process. Before such registration statement is filed, he is likely to have surrendered irrevocable power and dominion over his securities to a protective committee. Registration of the securities to be issued under the plan will usually come too late to benefit him. Of primary importance will be information concerning the protective committee which asks for his power of attorney, with or without custody of his securities.

There can be little dissent from the proposition that security holders are entitled to as complete information from those seeking their proxy or the deposit of their securities as it is practicable to convey. But the history of reorganizations shows that security holders have generally received declarations of pious intention, intimations of threatening disaster, and urgent calls to union instead of facts as to the interests and plans of those asking for control of their securities. The security holder has received a circular letter from the group soliciting his support; he has not received a copy of the deposit agreement describing the rights which he surrenders and which the protective committee acquires. Neither the circular letter nor the

[29] Mention should also be made of §12(d) of the Securities Exchange Act which authorizes the Commission to impose conditions upon delisting. Delisting of securities called for deposit may be used in reorganization to exert pressure upon security holders to exchange their securities for listed certificates of deposit. The decline in market value of the called securities together with fear of loss of liquidity which may result, may induce hesitant holders to deposit their securities. *Cf.* Hearing before the S. E. C., In the Matter of the Celotex Company (1935) pp. 390 *et seq.*

[30] Certificates of deposit for a security are expressly included within the definition of the term "security." Securities Act, §2(1). It is possible that some proxies, authorizing the holder to act for the owner of the security for purposes of reorganization and vesting substantial powers in the holder, may be considered "securities" and therefore subject to the registration requirements of the Securities Act. See *id.*, §2(1). The Commission has not as yet ruled upon this question.

By amendment to the Act in 1934, members of the usual type of protective committee were relieved of individual liability as "issuers" under the Act. *Id.* §2(4).

[31] For the registration requirements of the Act, see §§6 and 7 and Schedules A and B of the Act, and the various forms prescribed by the Commission, particularly Form D-1 (for certificates of deposit registered by protective committees) and Form D-1A (for certificates of deposit registered by the issuer of the securities called for deposit).

deposit agreement has described a plan of reorganization which the committee proposes or endorses. In a few instances, it is true, this is not the case. In these, a plan of reorganization is described to security holders when their consent is solicited. But in the great majority, presumably a plan of reorganization has not been formulated when the committee asked for deposits. In these, the committee asks security holders to give it blanket power over their securities, to be used in favor of such reorganization plan as the committee may later propose or approve. To the depositor is given only the privilege to withdraw his securities within a limited time if he does not like the committee's plan; and, in order to evidence his dissent, he must pay an assessment. Knowledge of the ways of investors and studies of actual behavior make it clear that this is in substance a denial of the privilege to dissent.

The security holder is given no information by which he may judge the reliability or the qualifications of the committee to bear this broad trust. Unless he has independent knowledge of the members of the committee, he remains unenlightened as to their connections, and even if the security holder knows the committee members, he probably is not aware of their financial interest in the reorganization. Only rarely do deposit agreements make any disclosures of the business affiliations of committee members, and most of these are merely statements of the principal business of the members. The deposit agreement generally neglects to state whether the members of the committee own any of the securities which they purport to represent or if they own securities with conflicting claims. The security holder, therefore, in a large majority of cases, deposits his securities with a committee concerning whose interests he knows little or nothing and of whose plans he is not informed.

Whether the security holder relies upon his own judgment or hunch, or acts upon the advice of investment counsel, broker or banker, lack of information makes impossible informed judgment. If all committees were required to register under the Securities Act, this deficiency might be supplied. But as I have previously stated, the registration requirements of the Act are applicable to very few committees.

From the effective date of the Act to September 1, 1936, 302 registration statements were filed for certificates of deposit. Of these, 287 were filed by protective committees and 15 by corporations in reorganizations. Hundreds of protective committees and corporations, in addition to these, during the same period were, without doubt, soliciting proxies and deposits of securities. Most of these, it is clear, were exempt from the provisions of the Act by virtue of Section 3(a)(1), because they had issued certificates of deposit prior to the effective date of the Act. But many which commenced activity after the effective date were exempt under other provisions of the statute. I believe that it is a conservative estimate to say that about 75 per cent of all committees commencing to operate after the effective date of the Act would not have to comply with the registration provisions of the Act.

III. EXEMPTIONS UNDER THE ACT[32]

Many of these committees are exempt under Section 3(a)(10) of the Act, on the ground that the terms and conditions of the issuance and exchange of the certificates of deposit had been approved, after hearing, by a court or authorized agency of the United States or of a State.[33] Others are exempt under Section 3(a)(2). These are principally committees representing securities issued by drainage and irrigation districts and by municipalities. A few need not register because of Section 3(b) of the Act, on the ground of the small size of the issue, and under Section 3(a)(4) because they represent securities of eleemosynary institutions. A number are exempt under Section 3(a)(9), because they are acting in connection with the exchange of securities by an issuer "with its existing security holders exclusively where no commission or other remuneration [was] paid or given directly or indirectly for soliciting such exchange." A small number are exempt under Section 3(a)(11), since their activities are intrastate, as therein defined.

There is reason to believe that in the future the number of committees which must register under the Act will be infinitesimal. Resort to Section 77B of the Bankruptcy Act is becoming more frequent, and exemption from registration of certificates of deposit available in 77B proceedings is being obtained by correspondingly more committees.[34] Since August 27, 1935, Section 77 of the Bankruptcy Act has exempted protective committees in reorganizations of railroads under that section from the registration requirements of the Securities Act.[35] In addition there is some reason to forecast that committees and corporations in reorganization will increasingly use proxies or assents of a type which are not required to be registered.[36] The tendency to operate in this fashion is undoubtedly accentuated by the requirement in the Securities Act for registration of certificates of deposit, as well as by the use of Section 77B of the Bankruptcy Act as a medium for reorganizations. It is not necessary for a committee to have title to or possession of the securities in order to effect reorganization under 77B. For example, in the recent reorganization of The Baldwin Locomotive Works, neither the consolidated bondholders committee nor the preferred stockholders' committee solicited deposit of securities. Edward

[32] For a thorough treatment of this matter, see Throop and Lane, *Some Problems of Exemption under the Securities Act of 1933* (Jan. 1937) 4 LAW AND CONTEMPORARY PROBLEMS, 89.

[33] Exemption under this section, it should be remembered, may be granted by a state commission or official, properly authorized, as well as by a state or federal court.

[34] Securities Act, §3(a)(10), and see Bankruptcy Act, §77B(h). The latter contains an exemption from the Securities Act for securities issued pursuant to a confirmed plan under 77B. It is not clear whether it applies to certificates of deposit. The difficulty is indicated by the following quotation: "All securities *issued pursuant to any plan of reorganization* confirmed by the court . . . including . . . all certificates of deposit representing securities of or claims against the debtor which it is proposed to deal with under any such plan, shall be exempt . . . " (italics supplied).

[35] See §77(f). This exemption is applicable only if the issuer of the certificates of deposit is subject to §77(p). The latter section forbids, in general, solicitation of deposits or proxies for reorganization purposes except with the approval of the Interstate Commerce Commission. It exempts from its scope, among others, groups of not more than twenty-five security holders "acting for their own interests and not for others," through representatives or otherwise. For the I. C. C. regulations governing solicitation under §77, see C. C. H., BANKRUPTCY LAW SERVICE, par. 2001.

[36] See note 30, *supra*.

Hopkinson, Jr., partner of J. P. Morgan & Co. and Drexel & Co., and chairman of the consolidated bondholders' committee, testified before the Securities and Exchange Commission as to the reason for soliciting proxies rather than deposits:[37]

"Q. Why didn't your committee accept deposits or ask for deposits?

A. There were a variety of reasons. With the probability that the 77B procedure would be followed in the reorganization, it was extremely probable that deposits would never be required, and it would have involved, as we understood it at that time, registration of certificates of deposit, and a lot of expense which we wanted to avoid if possible.

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A. We hoped to avoid the expense of it, and if 77B was the method to be pursued, deposits would be unnecessary."[38]

John Converse, chairman of the preferred stockholders' committee, stated the same reasons for not soliciting deposits, and added that the committee also wished to avoid listing certificates of deposit on the exchange.[39]

Proxies or assents solicited for the purpose of reorganization under 77B are exempt from Commission control not only under the Securities Act, but also under Section 14(a) of the Securities Exchange Act.[40] Similarly, proxies generally solicited for purposes of railroad reorganization under Section 77 of the Bankruptcy Act are exempt from the control of the Securities and Exchange Commission.[41] And in any event the Commission's power over the solicitation of proxies under the Exchange Act is applicable only in respect of securities registered on a national securities exchange. The result is that a large proportion of proxies solicited in reorganization proceedings is free from Commission control under both Acts. In fact, the only type of reorganization which has been subject to the Commission's regulations under Section 14(a) in any volume is reclassification of capital stock. Prior to the recent decision of the Supreme Court of Delaware in *Keller v. Wilson & Co.*,[42] a great many corporations sought to reclassify their stock and to eliminate unpaid dividends on their preferred stock which had accumulated during the depression. Many of the endeavors to solicit proxies in order to consummate plans came within the Commission's jurisdiction under Section 14(a). Considerable doubt exists, however, as to the adequacy of the Commission's power even in respect of this limited type of case. It is beyond the scope of this article to analyze this situation.[43]

[37] Hearing before the S. E. C., In the Matter of The Baldwin Locomotive Works (1935) p. 414.

[38] Witnesses in other hearings before the Commission gave similar reasons for not soliciting deposits.

[39] *Op. cit. supra* note 37, at 435-436.

[40] Securities Exchange Act Release No. 461, Jan. 21, 1936, C. C. H., STOCK EXCHANGE SERVICE, par. 2754.01.

[41] §77(f); C. C. H., *op. cit. supra* note 40, par. 2753A.

[42] Not yet reported. See *N. Y. Herald Tribune*, Nov. 11, 1936. This decision overruled an earlier decision of the Delaware Chancery Court in Morris v. American Public Utilities Co., 14 Del. Ch. 136, 122 Atl. 696 (1923).

[43] See the case of Consolidated Film Industries, Inc. This company filed with the Commission a copy of its material for soliciting assents to a proposed recapitalization. It appeared to the Commission that certain of the statements therein "might" be misleading. The company, however, refused to rectify the claimed deficiencies or to appear before the Commission to defend its position. Rectification would probably have involved re-solicitation of proxies. The Commission therefore made public an opinion stating the alleged misleading statements. This opinion was published the day before a scheduled stock-

With respect to the situations which are exempt from registration under the Securities Act, it is important to ascertain, first, whether an adequate substitute for the disclosure requirements of the Securities Act is applicable to them; and second, whether other adequate controls are applicable, which may be different in kind from the provisions of the Act. The reasons for the exemptions are moderately clear. It must be borne in mind that most of the sections conferring exemptions are not peculiarly directed to reorganizations. Certain of them, like those excluding issues offered prior to the effective date of the Act[44] and issues sold only intrastate by an issuer resident and doing business within the state,[45] were probably induced by legal considerations, and by desire to reduce the total administrative load. Constitutional difficulties may also have influenced the exemptions of governmental and quasi-governmental issues,[46] although it is not clear that those difficulties make necessary exemption of certificates of deposit for such issues.[47] In addition, this exemption may have been motivated by administrative difficulties which may be inherent in any endeavor to regulate governmental and quasi-governmental agencies. In any event, a Report of the Securities and Exchange Commission to Congress has shown the necessity of regulating the readjustment of the funded debt of municipal and certain types of quasi-municipal securities.[48] This Report discusses the virtually complete lack of control over this process and the necessity for comprehensive regulation.

Desire to reduce the total administrative load and to refrain from imposing disproportionate burdens upon small issuers probably motivated Section 3(b), which permits the Commission to exempt small issues. The most significant exemptions, in so far as reorganizations are concerned, are those provided by Sections 3(a)(9) and 3(a)(10) of the Act. From the viewpoint of protection of security holders, it is to be supposed that these exemptions are based on the assumption that the method of reorganization to which they relate makes unnecessary disclosure under the Securities Act. In addition, the exemption under Section 3(a)(10) may have been motivated in part by a desire to avoid overlap and possible conflict with the courts and other governmental agencies.

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holders' meeting to ratify the plan. It received considerable publicity in the newspapers. See *N. Y. Herald Tribune*, Oct. 22, 1936. Nevertheless, the plan was confirmed at the stockholders' meeting. *Id.*, Oct. 24, 1936.

The New York Supreme Court had denied complaining stockholders an injunction restraining holding of the meeting. *N. Y. L. J.*, Oct. 24, 1936, at p. 1347. Subsequently, however, the chancery court of Delaware issued an order restraining the company from filing a certificate of amendment of its charter, pending determination of proceedings to show cause. *N. Y. Times*, Nov. 1, 1936. After the decision in Keller v. Wilson & Co., *supra*, the plan was at least temporarily abandoned. *N. Y. Herald Tribune*, Nov. 18, 1936.

[44] Securities Act, §3(a)(1).

[45] *Id.*, §3(a)(11).

[46] *Id.*, §3(a)(2). *Cf.* Ashton v. Cameron County Water Improvement District No. 1, 56 Sup. Ct. 892 (U. S. 1936).

[47] The inclusion of certificates of deposit within the scope of this exemption was added by amendment in 1934.

[48] S. E. C., *op. cit. supra* note 3, Part IV. See also Report of Hon. J. Mark Wilcox in Public Hearings of a Sub-committee of the Select Committee on Investigation of Real Estate Bondholders' Reorganization, House of Representatives, 74th Cong. 1st Sess., Nov. 11-13, 1935, Part II, pp. 1-11.

Section 3(a)(9) is not, of course, generally applicable to certificates of deposit issued by protective committees in exchange for outstanding securities. The committee is not the "issuer" of the securities for which the certificates are exchanged. But if no protective committee intervenes, and if the issuer offers new securities to its "existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange," no registration statement need be filed. If the issuer solicits proxies for securities registered on a national securities exchange, disclosures will have to be made under the Commission's regulations pursuant to Section 14(a) of the Exchange Act, as previously discussed. In most cases, however, and for the most part, the issuer is in complete control of the terms which it offers to security holders and of the methods and manner of solicitation of approval of the proffered exchange. In substance, this means that the directors of the corporation and its bankers are in a position, without check or restraint except such as is supplied by an infrequent opposition group, to carry out whatever reorganization plan they may conceive. It is impossible in this article to analyze and discuss the dangers implicit in this procedure. The Securities and Exchange Commission in the course of its study of protective committees has investigated a number of instances in which so-called voluntary plans proposed by management and bankers have promoted interests of the proponents, adverse to those of security holders.[49] In some of these, the financial stake of the reorganizers was in securities or claims competitive with those of security holders; or management and bankers were confronted with possible legal liability to the corporation or to security holders, risk of the imposition of which would be averted by reorganization.[50] The supposed familiarity of security holders with the affairs of their corporation and its controlling personnel is no defense for them against management and bankers so motivated. They have not the information with which to challenge the case made by the management and bankers in favor of the plan; they have no means of compelling such information; and if they could obtain it, it is questionable if they could use it advantageously. Their training might not equip them to comprehend its intricacies; or their judgment might indicate that it is useless to resist. In most reorganizations of this sort, even appraisal of the stock of dissenters is not available as a remedy for the dissident and a check upon the reorganizer, and it probably does not require argument to show that the appraisal statute, even where it applies, is not always an adequate or a completely happy control. Apart from the appraisal statutes, control over these voluntary reorganizations exists, by and large, only in the jurisdiction of equity courts to enjoin extreme cases where fraud or gross unfairness can be shown.[51] The exemption of such cases, then, granted by Section 3(a)(9) of the Securities Act cannot be accepted as meaning that control

[49] See, *e. g.*, S. E. C., *op. cit. supra* note 3, Part III, pp. 44-48. Other instances of this sort will be discussed in forthcoming parts of the Commission's Report to Congress.

[50] *Ibid.* A notable instance of control of reorganization by management and bankers subject to possible legal liability is the attempted "voluntary" reorganization of the Frisco road in 1932. See Hearings before the S. E. C., In the Matter of St. Louis-San Francisco Railway Co. (1935).

[51] See notes 5 and 11, *supra.*

over such reorganization is not necessary. On the contrary, it leaves clear and unobscured the necessity for regulation.[52]

Appraisal of the cases exempted by Section 3(a)(10) of the Securities Act, and consideration of the adequacy of the controls exercised by existing state and federal agencies, contemplated in Section 3(a)(10), require extended treatment far beyond the scope of this article. Reference must be made to a forthcoming Report of the Securities and Exchange Commission to Congress, which will analyze this situation in detail. This Report will, it is contemplated, relate and discuss the activities of receivership and bankruptcy courts, of the Interstate Commerce Commission[53] and of various state agencies like the Michigan Public Trust Commission,[54] in supervising and controlling reorganizations. In this article, I can make only a few observations with respect to the work of federal courts under Section 77B in supervising the reorganization process.

IV. Supervision of Committees Under 77B

It is of course dangerous to venture wholesale comment concerning the quality of supervision which courts have exercised under the broad powers of Section 77B. The character of administration has varied from district to district and from judge to judge. But it is comparatively safe to say that under 77B investors whose securities are involved in reorganization have not received a new deal. The traditional has been taken as the standard. For example, instances are known in which protective committees have won approval of the "terms and conditions" of issuance of their certificates of deposit, making available the exemption under Section 3(a)(10) of the Securities Act, by displaying other deposit agreements containing the same provisions. And in other respects, the much criticized pattern of behavior before 77B became law has been accepted as the norm for procedure under the new statute.[55]

Section 77B gives the courts extremely broad powers over the reorganization process. In particular, they may disregard "any limitations or provisions of any depositary agreements, trust indentures, committee or other authorizations. . . ."[56] Under Section 77B(h), "All securities issued pursuant to any plan of reorganization confirmed by the court" are exempt from registration under the Securities Act. This section may or may not exempt all or certain certificates of deposit issued as part of the process of reorganization.[57] In any event, exemption of certificates of deposit is available if the procedure of Section 3(a)(10) of the Securities Act is followed.

There is, in fact, evidence that the conditions precedent to exemption, contained in 3(a)(10), have become little more than a specification of procedure. Before

[52] Facts which have been developed in current hearings of the Securities and Exchange Commission, in the course of its study of investment trusts (under the Public Utility Holding Company Act of 1935, §30) emphasize this necessity. Reference to the record of these hearings will disclose many instances of merger, consolidation and reclassification of stock which seem motivated solely by promotional schemes of those in control, detrimental to many of the affected security holders.

[53] See note 35, *supra*.

[54] See note 8, *supra*.

[55] See Douglas, *Protective Committees in Railroad Reorganizations* (1934) 47 HARV. L. REV. 565; Dodd, *Reorganization Through Bankruptcy* (1935) 48 *id.* 1100; Lowenthal, *The Stock Exchange and Protective Committee Securities* (1933) 33 COL. L. REV. 1293.

[56] See §77B(b).

[57] See note 30, *supra*.

solicitation of deposits, committees participating in reorganizations under 77B will file with the court a petition for approval of the "terms and conditions" of issuance and exchange of their certificates of deposit.[58] In most cases, if the deposit agreement is in conventional form, such approval is granted and exemption follows. Indeed, committees, far from being subjected to additional restraint by this procedure, have usually managed to emerge with a net profit. Having obtained court approval the committee proceeds, with the court's permission, to print on its circulars a statement that the court "has approved the fairness of the terms and conditions of the issuance and exchange by this Committee of the certificates of deposit. . . . Such approval, however, is not to be deemed to mean that any Plan of Reorganization . . . has been approved by said Court."[59] That statements of this sort aid the committee to persuade security holders to deposit, seems clear.

Unfortunately, however, the court's approval does not always follow careful scrutiny. Indeed, instances of exercise of the court's scrutiny power under 77B are not frequent, although some improvement in this respect may be noted, as compared with the control exercised in the old equity reorganizations. I believe that the following conclusions, based upon general observation and upon detailed study of a sample group of 77B cases in two federal districts, is moderately well-supported:

1. In individual cases, judges have exercised active and detailed control;[60] but the aggregate quality of administration does not bear this characteristic.[61]

[58] Apparently, this petition is filed at or shortly after the time of filing petition to intervene. Sometimes petition for approval is filed at or about the time of confirmation of plan. The purpose of the latter may be to prepare the way for solicitation of deposits under the confirmed plan; or broad approval of committee activities may be sought as a basis for allowances in the proceedings or as possible protection from suit against the committee.

[59] *In re* Saenger Theatres, Inc., C. C. H., BANKRUPTCY SERVICE, par. 3081 (E. D. La. 1934).

[60] See *In re* Butterick Co., C. C. H., BANKRUPTCY SERVICE, par. 3595 (S. D. N. Y. 1935) (in course of holding that bondholder could address communication to others of his class, court specified requirements for contents of communication), with which compare *In re* Schroeder Hotel Co., *U. S. Law Week*, November 24, 1936, at p. 3 (C. C. A. 7th, 1936) (court enjoined committee from communicating with bondholders on ground that its communications had been false, misleading and generally obstructive); *In re* Rosenbaum Grain Co., C. C. H., BANKRUPTCY SERVICE, par. 3468 (N. D. Ill. 1935) (court assumed general supervision over work of committees). For cases showing the exercise of jurisdiction over fees and expenses, see *In re* Republic Gas Corp., *id.*, par. 3721 (S. D. N. Y. 1935); *In re* De Witt Clinton Co., 11 F. Supp. 829 (S. D. N. Y. 1934); *In re* Wayne Pump Co., 9 F. Supp. 940 (N. D. Ind. 1935); *In re* A. Herz, Inc., C. C. H., BANKRUPTCY SERVICE, par. 3806 (C. C. A. 7th, 1936); *In re* The Celotex Co., *id.*, par. 3608 (D. Del. 1935), with which, however, compare Hearing before the S. E. C., *In the Matter of The Celotex Company* (1935); *In re* Kentucky Electric Power Corp., 11 F. Supp. 528 (W. D. Ky. 1935); see also *In re* Kelley-Springfield Tire Co., C. C. H., BANKRUPTCY SERVICE, par. 3720 (D. Md. 1935). See also the interesting case of *In re* 1775 Broadway Corp., 79 F. (2d) 108 (C. C. A. 2d, 1935) (court struck out provision in plan releasing liability of trust company which was trustee for, and underwriter of, the notes).

As to supervision of allowances under 77B generally, see Alley, *Some Corporate Reorganization Problems* (1936) 22 A. B. A. J. 557.

The tendency of some courts to disallow expenses and compensation to independent committees and groups on the grounds of "multiplicity" and "no service to the estate" is not altogether happy. In this general connection, see *In re* National Department Stores, Inc., C. C. H., BANKRUPTCY SERVICE, par. 3539 (D. Del. 1935); *In re* Paramount-Publix Corp., *id.*, par. 3637 (S. D. N. Y. 1935), and same case on appeal, *id.* pars. 4178, 4179 (C. C. A. 2d, 1936).

[61] But see *Developments in the Law—77B* (1936) 49 HARV. L. REV. 1111, 1159. The statement in that note that ". . . the courts have taken at face value the provisions of Section 77B dealing with com-

2. Deposit agreements are indistinguishable, with comparatively few exceptions, in respect of powers vested in committees and rights surrendered by depositors, from those in use by committees not subject to 77B.
3. In the comparatively few instances where courts have required changes in deposit agreements as a condition to approval, the changes generally consist in modification of the provision for assessment upon withdrawal, usually in the form of setting a maximum for the assessment. This maximum is usually a liberal figure, around 2% of the face value of the securities.
4. Courts have in some instances "disregarded" deposit agreement provisions. Some instances of this are not reflected by the record of the proceedings. One instance is known, however, in which the court conditioned its order approving the deposit agreement by providing that dissent from the plan could be entered by any security holder without withdrawal of his securities; if withdrawal were sought, no charge could be imposed unless first authorized by the court. Provision for dissent without withdrawal has been made in several other proceedings.
5. The records studied indicate that only in a very small percentage of cases did the court make any investigation of the qualifications of committee members.[62]
6. The courts have apparently exercised considerable discretion in awarding compensation and allowing expenses out of the estate.[63]

In short, the record of court supervision, on the whole, is not reassuring. Individual cases there are in which the court has exercised in the fullest way its power over the reorganization process. But by and large, the record is one of formalism—of compliance with the forms of the new procedure without materially affecting the old patterns of behavior. By and large, neither the broad provisions of 77B nor the specifications of Section 3(a)(10) of the Securities Act seem to have resulted in substantially fuller disclosure of material facts concerning the qualifications of committee members or their plans. By and large, the courts have not insisted that disclosures be made comparable to those required for registration under the Securities Act. Nor have they generally brought about changes in the methods of effecting reorganization and in the character of reorganization plans which would make disclosure to security holders of secondary or theoretical importance only.

The relevancy of these conclusions to any appraisal of the effect of the Securities

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mittees, and in numerous instances have utterly disregarded any deposit agreements and committee authorizations that appeared unreasonable" is not supported by the study referred to in the text. It is probably true, however, that powers of scrutiny were exercised in many cases in an informal fashion, not reflected in the records which were analyzed.

[62] But see *In re* Rosenbaum Grain Co., *supra* note 60. In one of the cases studied in the Northern District of Illinois, a plan was rejected for several reasons, including the facts that "a history of the committee members and their qualifications had not been submitted to the Court," the deposit agreement had not been submitted, and the committee had failed to advise the court of the charges which it contemplated making to depositing bondholders.

In addition, the indirect influence upon committee personnel of the court's attitude toward allowances of fees and expenses should not be overlooked.

[63] See §77B(c)(9) and note 60, *supra*.

Act upon reorganization procedure is readily seen. If they are accurate, the result is that a large number of reorganizations have been exempted from the disclosure requirements of the Securities Act, although no adequate or clearly better regulation obtains. The importance of these exemptions is indicated by answers which a prominent statistical agency submitted in response to an inquiry as to the assistance which they derived from registration statements for reorganization securities. This agency stated that registration statements generally were not available until after a reorganization plan had been confirmed. Consequently, the agency had to advise its clients as to depositing with protective committees and assenting to plans of reorganization without the benefit of the information generally elicited in a registration statement. It indicated that registration statements, when available, were of assistance to its work. The agency's reply to the inquiry was the following:

"1. To what extent registration statements are used in our work regarding reorganization plans.

"The answer is that we do not use these statements in deciding whether a plan is or is not equitable. Most of the cases we handle are under the amended Bankruptcy Act and registration statements are not available until after the plan is confirmed by the court and new securities are to be issued. Obviously, we must advise our clients long before the court confirms the plan.

"2. Whether registration statements have materially facilitated our work.

"As explained above they have not helped in forming an opinion as to a plan, but they are used in writing up our descriptive material regarding the new securities and the reorganized company. As such they help to give a better understanding of the value of the new securities.

"3. Have the registration statements made it possible for us to obtain more information concerning Protective Committees than we could obtain without such statements.

"This is answered under query No. 1."

Two propositions, I believe, follow: first, that the registration requirements of the Securities Act are applicable to an exceedingly small number of securities concerned in reorganization; and second, that adequate controls do not exist for those reorganizations to which the registration requirements of the Act are inapplicable. It is in order, then, to inquire specifically into the effectiveness of the registration requirements of the Act and of the theory of the disclosure in the comparatively few reorganization situations where registration is required.

V. LISTS OF SECURITY HOLDERS

Before discussing the basic aspects of registration, it is convenient to comment upon an important phase of registration under the Commission's prescribed forms which relates to a matter of vital concern in reorganizations. This is control over lists of security holders. It has long been recognized that one of the keys to the control by management and bankers over reorganizations is their possession of and

ability to obtain the names of security holders.[64] Because of this, they have been able to communicate with investors and to win their support. By the same token, opposition to the management and bankers has been subject to great difficulties. Without lists, the opposition has been under a terrific handicap in presenting its case to security holders and marshalling their support.

The forms prescribed by the Commission for registration of certificates of deposit have provided that a list of persons to be circularized must be filed with the registration statement or that such a list must be made available for examination.[65] Lists of holders would thereby presumably be available to opposition groups.[66] This move, promising as it seems, has been of little ascertainable utility. The lists filed with the Commission have generally contained a mere handful of names, and it is said that many of these were not names of security holders. Perhaps the explanation for this is that accurate and substantial lists were not available to the committees filing statements at the time of filing. It is not unreasonable to suspect, however, that some of these committees obtained accurate and fairly complete lists shortly after beginning to solicit. While it may be unusual for a committee to begin its activities with a complete list of every beneficial holder, even though the committee is sponsored by management and bankers, it is not customary for such a committee to begin operations without a substantial number of accurate names. Management and bankers are in the habit of making preparation in this respect for a rainy day.[67]

VI. THE THEORY OF DISCLOSURE AS APPLIED TO REORGANIZATIONS

Turning to the basic theory of disclosure in the Securities Act, I believe that it is inadequate, both in theory and in practice, to provide the controls for reorganizations which are necessary. In the first place, in theory, disclosure is of little practical utility to investors whose securities are involved in reorganization. It may be true that all that need be done to aid the public in making judgments as to the advisability of buying securities, has been done when they are given complete and accurate information. Prospective investors have, by and large, a real choice—to buy, or not, as their judgment indicates. But a holder of defaulted securities has no such free choice. He holds the securities and his choice is drastically limited. In the typical situation, a protective committee preempts the field, and the holder must go along with it or accept the possibility of less favorable treatment.[68] The existence of a

[64] See S. E. C., *op. cit. supra* note 3, Pt. III, pp. 252 *et seq.*, Pt. IV, pp. 67 *et seq.* Section 77B(c)(4) provides that the court may direct the debtor to prepare lists of all known bondholders, claimants and stockholders, which will be available to the inspection of any stockholder creditor of the debtor.

[65] See Forms D-1 and D-1A.

[66] In this connection, see note 64, *supra*, and especially S. E. C., *op. cit. supra* note 3, Pt. III, pp. 252 *et seq.*, discussing the procedure adopted by Mr. Justice Lockwood of the New York Supreme Court for controlling lists.

[67] See, for example, the instances in which trustees friendly to or identified with management or bankers have delayed notice of default while protective committee machinery was being perfected and strategy formulated, related in S. E. C., *op. cit. supra* note 3, Pt. VI, pp. 37-42.

[68] It is impossible within the limits of this article to discuss the treatment accorded dissenters in reorganization. It must suffice to say that the history of reorganizations shows that they have generally

strong and able opposition committee is unusual. The "inside" committee, usually sponsored by management and bankers, offers the security holder a take-it-or-leave-it proposition. In this situation, he can derive small comfort from the possible disclosure of facts leading him to believe that the protective committee is composed of rascals and the plan is oppressive.

Furthermore, the disclosures in the registration statement present the facts as of the effective date of the registration statement.[69] At that time, the committee may not have formulated or approved a plan of reorganization. The statement may indicate a protective committee composed of qualified individuals. On the basis of these facts, the security holder may deposit his securities. Subsequently the committee may promulgate a plan of reorganization which is unsound or unfair to depositors. Even if the complete facts with respect to this reorganization plan are disclosed, there is nothing which the security holder can do. Under the typical deposit agreement he has irrevocably surrendered dominion over his securities and he can compel their return to him only in a few instances and under oppressive conditions.[70] After the security holder has deposited, he has absolutely no control over the protective committee. In some respects, he does not have as much power over the committee as a stockholder has over the management of his corporation. A stockholder, for example, may vote for new directors if he is displeased with the old. But in the present state of reorganization law and practice, the depositor has no comparable control over the personnel of his committee.[71]

In short, none of the practices in which protective committees are currently engaged is forbidden by the filing of a registration statement. If the registration statement contains no misstatements or non-disclosures of material facts, protective committees may continue, without restraint so far as the Securities Act is concerned, to operate under oppressive deposit agreements; they may continue to vote themselves such fees and expenses as they decide; they may continue to trade in the securities which they purport to represent; and they may continue to distribute patronage with scant regard for the interests of their beneficiaries. Under the Securities Act, the

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received less favorable treatment than assenters; at best, they have been compelled to accept the same treatment. There are exceptions, as in certain well-known reorganizations in which dissenters were paid off in full. This matter will be discussed in forthcoming reports of the S. E. C. to Congress. For a discussion of some aspects, see S. E. C., *op. cit. supra* note 3, Pt. VI, pp. 61-66.

[69] But see Securities Act, §10(b), requiring that information in prospectus be as of date not more than twelve months prior to its use. The Federal Trade Commission has ruled that "It is . . . unnecessary, and probably impossible, to amend it [the registration statement] to include facts which occur after its effective date." Securities Act Release No. 97, Pt. 14, Dec. 28, 1933. The same conclusion is expressed in Matter of Howard, 1 S. E. C. 6 (March 21, 1934). The legal basis for this conclusion, the Commission found in §11 of the Act which determines civil liability by reference to the date when registration becomes effective. This is not the place to analyze the accuracy of this conclusion as a matter of statutory construction or to discuss its wisdom.

[70] With few exceptions committees require payment of an assessment as a condition to withdrawal; and withdrawal can be effected only if request therefor be made within a specified time (usually 15 to 30 days) after notice of accrual of the right is given by the committee.

[71] Committees are, with few exceptions, self-perpetuating. Their deposit agreements give them the right to remove and select committee members.

Commission has no power to regulate practices in any of these respects. And in part because of the monopolistic position of most committees; in part because of the failure of security holders to ascertain the facts set forth in the registration statement or to appreciate the significance of known facts; because of high-pressure solicitation methods of committees; because of the failure of committees to make full, current disclosures after filing their registration statement; and in part because of the perennial faith, trust and innocence of investors, these committees can obtain control of securities and effect reorganizations.

It is clear that in some cases the Commission's vigilance has stopped the activities of committees which did not deserve the confidence of investors. This result was obtained through vigorous enforcement of the disclosure requirements of the Act. But the machinery of the Act was not designed to accomplish the result; the Securities Act was not drafted or designed to provide effective control over reorganizations. It permits the escape of many committees which should not be allowed to operate. License to function depends not upon the qualification of the committee as a fiduciary, but upon the comparatively irrelevant fact of the extent of disclosure made.

An example of the inadequacy of the principle of disclosure under the Securities Act is afforded by an incident arising in connection with a registration statement filed by a committee representing debentures of a foreign industrial issuer. The committee had approved a plan of reorganization and in order to solicit deposits under the plan, it filed its registration statement. When originally filed, the statement specified that persons who had deposited their securities prior to approval of the plan might withdraw upon payment of $10 for each $1000 face amount of debentures. It was further stated that this payment represented the depositor's "pro rata share" of the accrued expenses and liabilities of the committee. Most of the expenses of the committee had been paid, however, by the bankers who underwrote the securities. The sum remaining to be paid, divided pro rata among the committee's depositors, did not amount to $10 per $1000 debenture. This was called to the registrant's attention by the Registration Division of the Commission. An amendment was filed which technically cured the inaccuracy. The amendment merely recited that the contributions to the committee's expenses made by the bankers would "not inure to the benefit of withdrawing depositors." It also eliminated reference to the withdrawal fee as the depositor's "pro rata share" of committee expenses. The result is that a security holder wishing to dissent from the plan must, after the amendment as before, pay $10 per $1000 debenture. The registration statement, however, is technically accurate and complete in respect of this item.

Further evidence of the inadequacy of the principle of disclosure for regulating committees can be cited. Committees have effected registration under the Act and have functioned effectively although they represented and served interests opposed to those of the security holders whose support they sought. Success has attended

efforts to consummate plans which seem, superficially, to be oppressive even though the registration statement discloses its apparently oppressive features. A case of the latter sort involved a filing by an issuer on Form A-2 of stock issues to be exchanged for outstanding shares of the company. The plan concerned the corporation's outstanding Class A and Class B shares. No equity existed for the Class B stock, substantially all of which was held by the officers and directors of the registrant. Nevertheless, the plan provided that one share of new Class B stock would be issued for each outstanding "B" share, while for five shares of the old "A" stock there would be issued six shares of new class A and five shares of new "B."

The registration statement as originally filed did not clearly disclose the comparative position of the holders of each class of stock, before and after the plan, in respect of their asset position. The registrant was required to file an amendment to the statement. As finally amended and distributed to stockholders, the prospectus of the plan contained on its cover page a table clearly showing that the Class B shares had no book value before the plan; that after giving effect to the plan, they had a book value of over $6 per share; and that the book value of each five shares of "A" stock was reduced by the plan from over $260 to about $184.

After the registration statement became effective with such disclosures, the company obtained approval of 84 per cent of Class A stockholders and of 96 per cent of Class B, apparently sufficient to consummate the plan. A minority brought suit to restrain consummation of the plan. This suit may have been, in part at least, the result of the clear disclosure compelled by the Commission. But on its face, at least, this case is a pointed indication that disclosure itself may not be enough.

Still further evidence of the deficiency of the principle of disclosure in respect of reorganization can be found in the history of the committee for the bonds of Chestnut Hill Apartments. This committee effected registration under the Act.[72] The registration statement disclosed, in cold and devitalized answers to several items, that the issue had been underwritten by S. W. Straus & Co. of California; that the four committee members were officials of Straus companies; that "the Committee is advised that S. W. Straus & Co., Incorporated, a New York corporation, holds directly or indirectly the title to the property. . . ."[73] No apprehensive shudders are likely to afflict the reader upon reading these facts as related in the registration statement. And judging from the success of the committee in obtaining deposits, either the facts in the registration statement did not cause alarm or they did not become known to security holders.

But the record of the investigation and hearing by the Commission, as part of its Protective Committee Study, in the matter of the same issue, conveys quite a different impression.[74] The facts disclosed in the registration statement are not shown to be inaccurate or necessarily incomplete. They are embellished with a full background of circumstances and with a development of motive which, I believe,

[72] Hearing before the S. E. C., In the Matter of S. W. Straus & Co. (1935) Commission's Exhibit 198.
[73] Reply to item 21, *supra* note 72.
[74] *Supra* note 72.

show that this committee was disqualified to represent holders of these bonds. I cannot attempt in this article to relate the complete story as it is reflected in the record. It must suffice to say that Straus had made advances to meet payments of principal and interest on the bonds in 1927, 1928, and 1929.[75] To secure these advances, the issuer gave Straus a second mortgage and Straus cancelled the bonds and coupons which it had acquired as a result of the advances.[76] Subsequently, Straus foreclosed the second mortgage and acquired title. [77] During all this time it was preventing default on the first mortgage by advancing funds from its own cashbox.[78] During all this time it was selling bonds of the issue at par.[79] In February, 1931, Straus sought to obtain from its bondholders a "voluntary" agreement extending the maturity of their bonds.[80] This plan was abandoned because of failure to get enough consents to prevent the remaining, non-assenting bondholders from compelling the trustee to foreclose.[81] In 1932, the committee which subsequently registered under the Securities Act proposed a plan of reorganization under which 45 per cent of the voting trust certificates would be issued to Straus of California in payment for title to the property.[82] There was no evidence that any equity would remain after foreclosure of the first mortgage for surrender of which this stock would be issued to Straus. The contemplated payment to Straus was abandoned by the committee only after receivership, when such payment would have inured to the sole benefit of Straus creditors.[83] None of the above transactions was disclosed in the registration statement. Some of them, of course, might be disclosed if the Commission's form required disclosure of past endeavors to reorganize the securities for which certificates of deposit are offered. But in the main, comparison of the record of the hearing with the registration statement indicates not deficiency in the Commission's form, but basic inadequacy of the technique. The committee which effected registration of this issue should have been absolutely disqualified to represent holders of Straus bonds.[84] Only the circumstance that Straus became insolvent prevented the committee from depriving bondholders of control of the enterprise and of 45 per cent of the equity. The most complete disclosure possible probably would not have prevented this. The application of elementary standards for fiduciaries[85] would result in disqualifying this committee, because of its pecuniary stake in and connection with Straus, the underwriter and equity owner.

From another point of view, the inadequacy of the theory of disclosure as applied to committees can be demonstrated. There is no evidence that the requirement of disclosure has caused modification of practices of the protective committees which have registered under the Act. The deposit agreements of these committees, as in

[75] *Id.*, at 1008, 1011, 1012.
[76] *Id.*, at 1016-1017.
[77] *Id.*, at 1019.
[78] *Id.*, at 1021.
[79] *Id.*, at 1022-1023.
[80] *Id.*, at 1053.
[81] *Id.*, at 1058-1060.
[82] *Id.*, at 1114-1115.
[83] *Id.*, at 1125-1126.
[84] See S. E. C. *op. cit. supra* note 3, Pt. III, pp. 100 *et seq.*
[85] For cases stating that members of protective committees are fiduciaries, see Note (1936) 46 YALE L. J. 143, notes 15 and 16.

the case of the committees which have not registered, generally vest in the committee title to or complete dominion over the deposited securities.

The committee is given power to pledge the securities in all but a few instances. A few of the deposit agreements give depositors no privilege of withdrawing their securities. Generally depositors may withdraw when the committee adopts or approves a plan, or amends a plan or its deposit agreement. In a minority of instances withdrawal is permitted in the discretion of the committee or upon abandonment of the plan. But in virtually all instances where withdrawal is permitted, it is conditioned upon prompt action and payment of assessments—requirements which make the privilege illusory as to most investors. Security holders are by and large unwilling to pay out money. The result of these restrictions upon withdrawal is that committees, once securities have been deposited, may deal with them virtually as they please, with complete immunity. They can adopt a plan, modify their deposit agreement, pledge the deposited securities and vote themselves fees and expenses with very little danger of effective dissent.

The deposit agreements for these committees indicate little improvement respecting restrictions upon profits which the committees may make from their activities. In most of the deposit agreements, express provision is made for committee members to vote themselves compensation and payment of expenses. In a majority of the instances, there is no maximum limitation upon fees or expenses; only a few make any provision for independent review of the compensation which they are empowered to vote themselves. In about one-fourth of the agreements, there is no provision for an accounting; in a few, accounting is discretionary with the committee. Most of the agreements providing for accounting stipulate that the accounting is conclusive upon all depositors who do not object or bring legal proceedings (or in some cases, both) within 15 or 60 days.

Moreover, the usual channels of profit in addition to direct receipt of fees and expenses are left open to members of committees which have filed registration statements. By express permission, many of them may trade in the securities called for deposit, acquire a pecuniary interest in the property, and make loans to the committee secured by pledge of the deposited securities. In only a handful of instances is trading in the securities called for deposit expressly forbidden; in about half, it is expressly permitted. In only a very few agreements is the acquisition of pecuniary interest in the property forbidden; in most, it is expressly sanctioned. About half the agreements authorize members to make loans to the committee, secured by pledge of the deposited securities. The possibility of additional patronage for committee members is assured by a variety of provisions in addition to the above. Significant among them are provisions allowing committee members to underwrite the securities to be issued under the plan, or to become officers, directors or voting trustees of the new company. To protect themselves from liability in the exercise of these broad powers and in the exploitation of opportunities for profit, virtually all

of the committees have inserted in the deposit agreements blanket exculpatory provisions, exempting them from liability except for fraud or wilful negligence.

It does not appear that the necessity to disclose has resulted in committee members whose interest in the situation arises solely from ownership of the securities. On a majority of the committees which filed registration statements, one or more members are connected with the underwriter of the securities represented; over half are affiliated with the trustee; some are connected with the issuer of the securities; and about half are affiliated with the depositary for the committee.[86] On the other hand, in about 52 per cent of the committees, not a single member personally owned any of the securities which the committee represented; and in 28 per cent of the cases, no member either owned any of the securities or was affiliated with a firm or corporation which owned any. In only a few cases do a majority of the committee members or their affiliates own any of the securities called for deposit.

VII. CONCLUSIONS

In the aggregate, then, it is clear that registration limited to disclosure under the Securities Act has not effected changes in protective committee qualifications or practices, nor has it exercised noticeably beneficent influence upon any important aspect of reorganization procedure. In fact, the elaborate evidence which has been summarized above is hardly necessary for the conclusion. The provisions of the Act themselves show that the registration requirements are applicable to comparatively few issues of reorganization securities, whether they be certificates of deposit or securities issued for exchange under the plan. Even if registration were required of all reorganization securities, sound theory indicates that the beneficial results would be slight. As I have discussed, disclosure is itself inadequate to protect investors in reorganization because of the absence of genuine opportunity for the expression of will and judgment. And nothing more than disclosure can be expected from registration under the Securities Act, in respect of reorganization securities.

In connection with the offering of new issues for purchase, it may be that disclosure of material facts and intelligent administration of disclosure requirements will exert influence over practices, pervasive and substantial, although subtle and gradual. This may result from inability readily to sell unsound securities if their weakness is disclosed, and from administrative suggestion.[87] But disclosure cannot

[86] Instances are known of persons becoming members of committees in order that banks with which they are connected may be appointed as depositary for the committee. See S. E. C. *op. cit. supra* note 3, Pt. IV, pp. 72-73.

[87] Suggestions made by the Commission or its officers may be accepted for a variety of reasons including the prestige of the Commission, desire to win its favor, or the recognition of the wisdom of the suggestions themselves. In addition, they may be adopted because the registrant wishes to induce the Commission to exercise its discretionary powers in favor of the registrant. That the Commission has adopted a broad view of the function of its discretionary powers is evidenced by statements in several of its opinions. It has stated that it will not exercise its discretion to consider the situation as of the time of a stop order preceding, if such consideration will "permit the registrant to escape the consequences of a neglect and folly that approaches fraud." Matter of Haddam Distillers Corp., 1 S. E. C. 37, 47 (1934). Similarly, it has proceeded with publication of findings and opinion despite consent to entry of a stop-order.

be expected similarly to affect the pattern of the institution of reorganization or the practices which thrive therein. There are several reasons for this. In the first place, the usual registrant of reorganization securities need not fear that disclosure will seriously hamper its success. I have already related the principal reasons for this. With respect to committees, there is the fact of virtual compulsion upon the security holder to deposit and the monopolistic position of most committees. With respect to securities issued under a plan of reorganization, there is the fact that most of the securities to be exchanged generally are committed to the plan. In the second place, reorganizers generally conduct themselves in accordance with a well-defined cultural pattern, sanctioned by time and acceptance by the leaders in finance and law. There are no formulated standards to guide them except the practices of their predecessors and contemporaries. From this viewpoint, they do no wrong, regardless of the injury they inflict upon investors, since they abide by the only existing code. The Securities Act provides no code; it merely prescribes that they show what they are doing—that they confess and so, perhaps, win absolution. In this state of affairs, there being conformity to usage, good or bad, neither conscience nor the law need prick. In the third place, little can be expected from administrative suggestion in respect of raising reorganization standards. Wise administrators may, by discussion and analysis, use the requirement of disclosure to educate the registrant's attorneys. Questions and discussion, directed to the accuracy of statements, may raise the possibility that the propriety of a practice is subject to challenge. Subtle appeals to a higher self may cause slight changes in practices. But the limitations of such possibilities are indeed strict. Perhaps the imponderable effect of an agency with high standards may in time permeate the practices of men; but skepticism concerning this possibility is indicated. Unless the administrator has effective bargaining power, little can be expected. It must have sanctions or desired favors which it can trade for changes in practices. Once in a while under the Securities Act, the administrator will have something to trade. It may have a choice as to whether a particular statement will be considered accurate and complete, or deficient. It may be asked to exercise its discretion, for example, to accelerate the effective date of registration. Then, if the need of the registrant is sufficiently urgent, a trade may be consummated. In return for the favor of the administrator, the registrant may amend its practices in accordance with the administrator's conception of equity and justice.[88]

There is no doubt in my mind that the Commission and its employees have utilized their powers in respect of reorganizations in a way which is remarkably worthy of commendation. The opportunities for exercise of administrative influence in connection with reorganization securities have probably been less frequent than

In the Matter of Big Wedge Gold Mining Corp., 1 S. E. C. 98, 100 (1935); In the Matter of General Income Shares, Inc., 1 S. E. C. 110, 111 (1935).

In my opinion, this is an earmark of wise and effective administration. But compare the opinion of the Supreme Court in Jones v. Securities & Exchange Commission, 298 U. S. 1 (1936).

[88] Note particularly the Commission's power to accelerate the effective date of amended registration statements. Securities Act, §8.

in the case of other issues. The principal reason for this is that in the former there is not the same pressure of time inducing the registrant to yield a substantive point rather than incur the delay incident to amendment. Typically, the prospective issuer of certificates of deposit or, to a less extent, of securities issued under a reorganization plan is not faced with the same degree of necessity of qualifying before expiration of a time limit upon an underwriter's commitment, or while an uncertain market is advantageous. Typically (although there are exceptions) it can take the necessary time to remedy such deficiencies as the Commission may cite, without bargaining for favorable exercise of administrative discretion. And, as I have said, generally it has little to fear from disclosure. Even so, inquiry and suggestion by the Commission have sometimes led to changes such as adoption of a maximum limitation upon fees and expenses, liberal though it may have been. In addition, inquiry in respect of both registered securities and non-registered issues[89] has probably resulted in some instances in voluntary modifications or changes in committee practices of a minor nature. And in some cases, alert inquiry and vigorous insistence upon full disclosure of all facts have put an end to the activities of committees which did not deserve the privilege of acting for security holders. The very fear of the Commission's inquiry has possibly dissuaded wishful entrepreneurs from forming committees; in others it is likely that manifestation of the Commission's vigilance has caused registration statements to be withdrawn. In some cases hearings have been held on registration statements for reorganization securities, and the attendant publicity has undoubtedly been salutary. In the reported cases involving reorganization securities in which the Commission has issued stop orders, it seemed eminently desirable that the committees concerned be forbidden to solicit deposits. One of these concerned a registration statement for certificates of deposit to be issued by Commonwealth Bond Corporation "as a committee" for bonds of an issue originally underwritten by Commonwealth.[90] Another concerned a committee none of the members of which was beneficially interested in the securities called for deposit.[91] Both stop orders were, of course, based upon failure to make necessary disclosures; but in both instances, the qualification of the registrant to provide loyal representation to bondholders is at least questionable.

On the whole, therefore, it is clear, as congressional direction of the Commission's investigation of protective committees implies, that something more than the provisions of the Securities Act is necessary. If the standards of reorganization are to be raised, rules prescribing committee qualifications and regulating their practices must be prescribed and machinery must be furnished for their enforcement, and ways and means must be found to insure the formulation of desirable plans of reorganization.

[89] The Commission has frequently communicated with issuers and protective committees, in connection with non-registered issues, concerning matters raised by letters of complaint.

[90] Matter of Commonwealth Bond Corp., 1 S. E. C. 13 (1934).

[91] Matter of Charles A. Howard, *et al.*, 1 S. E. C. 6 (1934).

THE RELATION OF FEDERAL AND STATE SECURITIES LAWS

RUSSELL A. SMITH*

State "Blue Sky" laws antedated by more than twenty years the Securities Act of 1933 and the Securities Exchange Act of 1934. At the time of the passage of those Acts every state but one had on its statute books legislation relating to the sale of securities. The entrance of the federal government upon the field did not result in a repeal of any of the state laws. Such laws remain extant and their administration has, if anything, received renewed vitality from the prevailing public interest in the regulation of transactions in securities. It is pertinent to examine briefly into the scope of the federal and state laws, to determine the extent to which they are concurrently applicable, and to ascertain the need, if any, for correlation of the regulatory functions of the federal and state governments.

State "Blue Sky" laws differ widely, evincing a lack of uniformity both in objective and in means for attaining similar objectives. It is apparently the policy of some states, as disclosed by their statutes, the administration thereof, or both, not only to prevent fraud by requiring factual disclosures and establishing penalties for misrepresentation and deceit, but also to prevent the sale of certain securities (on the theory, perhaps, that they are unsound or *per se* fraudulent) or the sale of any securities on terms not considered fair.[1] Other states, less paternalistic in this respect,

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[1] The following provisions, selected at random, are illustrative:

Section 9887 of the Alabama Securities Act, ALA. CODE (Michie, 1928) c. 335, provides that the commission shall refuse to qualify securities upon finding, *inter alia*,

"(a) That the sale of such securities would work a fraud, deception or imposition upon the purchasers thereof, or that the proposed disposal of such securities is on unfair terms; or

"(b) That the articles of incorporation or association, declaration or trust, charter, constitution, by-laws, or other organization papers of the issuer are unfair, unjust, inequitable, illegal or oppressive; or

"(c) That the issuers or guarantors of such securities are insolvent, or are in failing circumstances, or are not trustworthy; or

"(d) That the issuer's plan of business is unfair, inequitable, dishonest, or fraudulent; or . . .

"(f) That the reasonable value of any property or assets of the issuer for which the issuer has issued or proposes to issue securities is less than the par or face value, or the issue price, as the case may be, of all of the securities of the issuer so issued or to be issued in payment therefor; or . . .

"(h) That the sale of such securities is a mere scheme of either the issuer or the applicant to dispose of worthless securities of no real intrinsic value, at the expense of the purchasers of said securities; . . ."

Section 8 of the Florida Uniform Sale of Securities Act, Fla. Laws 1931, c. 14899, requires a finding

seek only to prevent fraud, leaving it to the individual purchaser to determine, unhampered by misrepresentation, the wisdom of his purchase.[2] Irrespective of their underlying policies, the various state laws may be roughly classified with respect to their objective requirements as follows:[3]

(1) the "fraud" type of law, which does not require either the "qualification" (*i.e.*, registration or approval) of securities or the "licensing" of dealers in securities but, in general, merely provides penalties for fraud and authorizes injunctive proceedings to prevent fraud;

(2) the "licensing" type of law, which, in general, requires dealers in securities to be licensed but does not require that securities be qualified;

(3) the "inspection" type of law which, in general, requires that securities be qualified but does not require that dealers be licensed; and

(4) the "licensing and inspection" type of law, which requires both that securities be qualified and that dealers be licensed and which is the most common type of law.

The duties of administration of the laws are variously reposed with the attorney general's office (customary in the case of a fraud law), some pre-existing body such as the corporation or public utilities commission, or, more frequently, a commission or an office created especially for the purpose. The administrative bodies are, as a rule, clothed with broad discretionary powers, in some cases unguided save by the vaguest standards.

COINCIDENCE OF FEDERAL AND STATE LAWS

If not inevitable, it is at least to be expected that to some extent the state and federal securities laws should be concurrently applicable. The federal laws purport primarily to be an exercise of the commerce power, and hence to be regulations of interstate transactions in securities. But every such transaction is, of course, only a sequence of intrastate acts having incidence in at least two states, and over all acts done within a state, whether or not they are related to acts done beyond its boundaries, the state may logically (in the absence of some constitutional barrier) assert jurisdiction. Thus, an offer to sell securities, made by dealer A in State X through

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by the Commission, prior to registration of securities, that, among other things, "the enterprise or business of the issuer is not based upon unsound business principles."

Section 27 of the New Hampshire Blue Sky Law, N. H. PUB. LAWS (1926) c. 284, provides as follows: "If the commissioner is of the opinion that such securities are of such a character that there is a serious financial danger to the purchaser in buying them, or that the circulars and advertisements do not disclose pertinent facts sufficient to enable intending purchasers to form a correct judgment of the nature and value of the securities, he may prohibit the dealer from selling or offering the securities, or any of them, or in any way advertising them."

Section 8 of the Vermont Securities Act, VT. PUB. LAWS (1933) c. 274, provides that the commissioner shall register securities upon application if he finds "that the sale of the security . . . would not be fraudulent and would not tend to work a fraud upon the purchaser, and that the enterprise or business of the issuer is not based upon unsound business principles, and that in his judgment the enterprise promises a fair return to the purchaser of its securities."

[2] Among such states are Delaware, Maryland, New Jersey, New York and Illinois. The first four of such states have the "fraud" type of law, whereas Illinois has the "licensing and inspection" type (see the classification immediately following in the text).

[3] See Smith, *State 'Blue-Sky' Laws and the Federal Securities Acts* (1936) 34 MICH. L. REV. 1135, 1137.

the mails to customer B in State Y, and accepted by B through the mails, resulting in delivery and payment in X—clearly an "interstate" transaction—consists, in fact, of certain acts in State X and certain acts in State Y. In State X there occurs at least a partial transmission of the offer, a partial transmission of the acceptance, and the delivery of and payment for the securities and, possibly, depending on the terms of the offer, the making of the contract. In State Y there occurs at least a partial transmission of the offer and a partial transmission of the acceptance, and, possibly, again depending on the terms of the offer, the making of the contract. If States X and Y have the "licensing and inspection" type of securities law, and if such law is intended to apply to such a transaction, under the facts stated, and waiving constitutional questions, A must be licensed as a dealer, and the securities must be qualified (unless exempt) under the laws both of X and Y, failing which the contract may be voidable at B's option either under the laws of X or of Y.

It has elsewhere been shown that under decisions of the Supreme Court, while the question is, unfortunately, not entirely free of doubt, the interstate character of such a transaction probably does not in and of itself preclude such an application of state laws.[4] It has also been suggested that while Congress could, either by express declaration or by implication through substantial occupancy of the field, supervene and withdraw from the states such jurisdiction as they may have over interstate transactions in securities, it has not done so in either of the federal securities acts, which, on the contrary, expressly preserve to the state securities commissions their pre-existing jurisdiction.[5] State laws may thus, depending probably only upon their scope,[6] be applicable to interstate transactions.

On the other hand, the federal laws are not restricted (except by constitutional barriers, if any) to transactions clearly interstate in character. The Securities Act of 1933 applies to sales of securities by "any means or instruments of transportation or

[4] Smith, *supra* note 3, at 1145 *et seq.* The leading cases there discussed are Hall v. Geiger-Jones Co. 242 U. S. 539 (1917); Caldwell v. Sioux Falls Stock Yards Co., 242 U. S. 559 (1917); and Merrick v. N. W. Halsey & Co., 242 U. S. 568 (1917).

[5] See Smith, *supra* note 3 at 1158. Section 18 of the Securities Act of 1933, 48 STAT. 74, 15 U. S. C., c. 2A, provides:

"State control of securities.—Nothing in this title shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person."

Section 28 of the Securities Exchange Act of 1934, 49 STAT. 881, 15 U. S. C., c. 2B, provides:

"The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this title shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. Nothing in this title shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this title or the rules and regulations thereunder."

[6] Many of the state laws apply only to "sales" made "in this state." Customarily, "sale" is defined very broadly to include offers, solicitations of offers and all attempts to sell. It is a question of statutory construction of such definition of "sale" whether an offer originating in a foreign state and made through the mails or some other interstate instrumentality constitutes a sale within the state in question. Except for such broad definitions, an offeror in one state could successfully avoid the application of the laws of other states by providing that contracts should not be deemed made until communication of acceptances.

communication in interstate commerce or of the mails."[7] Whether or not a sale of securities by A in State X to B in State X, concluded by telephone, is a transaction within the Act because the telephone is, potentially, a means of communication in interstate commerce, in any event a sale completed between A and B by mail is expressly within the Act. The intended scope of the Act is further indicated by the fact that there is included an express exemption of intrastate transactions of very limited application. Securities are exempt from registration requirements under this provision only if the entire offering is confined to the state of domicile of the issuer.[8] In other words, if A in State X offers unregistered securities to B in State X, when neither the security nor the transaction is exempt, he violates the Securities Act of 1933 if any part of the offering is made in another state or if the issuer is a corporation of some other state.

Similar observations may be made concerning the Securities Exchange Act of 1934. Assuming that a "national securities exchange," within the meaning of the Act, is an instrumentality of interstate commerce, specific subjects covered by the Act are not clearly interstate in character. Thus, to mention a few instances, the Act provides for margin requirements in connection with loans on any security (other than an exempted security) registered on a national securities exchange, whether or not the loan is arranged for in interstate commerce, and whether or not the purpose of the loan is to effect a purchase of the security on the exchange.[9] Members of a national securities exchange (and persons who transact a business in securities through the medium of a member) are subjected to restrictions on borrowing applicable to all their transactions, even those entirely dissociated from the exchange.[10] The facts (1) that a person is a member of a national securities exchange (or transacts a business in securities through the medium of a member) and (2) that he engages in a transaction relating to a security (other than an exempted security) registered on a national securities exchange are made the basis for subjecting him to certain restrictions (*viz.*, margin requirements, prohibitions against manipulation, regulation of the solicitation of proxies) even though such transaction is purely local and not consummated on the exchange.[11]

[7] Securities Act, §§5, 12, 17.

[8] Thus, §3(a)(11) exempts "any security which is a part of an issue sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident within, or, if a corporation, incorporated by and doing business within, such State or Territory." Under this provision it may be that even if an entire issue is sold in the state of incorporation of the issuer, the exemption does not apply if the issuer is not "doing business"—*i.e.*, actually conducting its operations—in such state. For a discussion of §3(a)(11), see Throop and Lane, *Some Problems of Exemption under the Securities Act of 1933*, in Part I of this symposium (Jan. 1937) 4 LAW AND CONTEMPORARY PROBLEMS, 89, 107 *et seq.*

[9] Section 7(d) provides: "It shall be unlawful for any person not subject to subsection (c) to extend or maintain credit or to arrange for the extension or maintenance of credit for the purpose of purchasing or carrying any security registered on a national securities exchange, in contravention of such rules and regulations as the Federal Reserve Board shall prescribe to prevent the excessive use of credit for the purchasing or carrying of or trading in securities in circumvention of the other provisions of this section. . . ."

[10] Securities Exchange Act, §8.

[11] *Id.*, §§7, 9, 14.

It thus appears that persons dealing in securities may find themselves apparently subject both to state and federal regulation. The significance of this fact, so far as the federal requirements are concerned, has been the subject of extended discussion and is comparatively well known. The problems presented by the state laws are not so well known, nor has the value of or necessity for concurrent state regulation been adequately appraised. A brief survey of certain of the problems which may arise under the state laws in connection with transactions which, with one exception, ordinarily require registration under the Securities Act of 1933 will indicate the need for such an appraisal. The purpose will be, for the most part, rather to state the problems than to answer them. It is assumed for the purpose of this discussion that there exists no immunity from the state laws by virtue of the interstate character, if any, of such transactions.

PARTICULAR "BLUE SKY" PROBLEMS

(1) *Transactions by Issuers—Offers to Stockholders, Mergers, etc.*

Suppose X, a Delaware corporation, having its principal place of business in New York, and having numerous stockholders scattered throughout the country, desires to make an offer of a new class of preferred stock (convertible into common stock) to its existing preferred stockholders, in exchange, share for share, for outstanding preferred stock, and to make an offer to its common stockholders of any of such stock not taken by the preferred stockholders, the offers to be underwritten by certain bankers who will receive, as compensation for their commitments, a stipulated sum for each share of stock offered, plus an additional sum for each share of stock which is purchased by them. Preferred stockholders desiring to accept the offer will be required to deposit their shares with a specified depositary in New York or San Francisco. The outstanding common stock of the Company is listed on the New York Stock Exchange. The "Blue Sky" questions which arise are several.

Since the offering is to be made *in* New York, as to New York stockholders, the first state securities law to be examined is the New York "Martin Act."[12] In its affirmative requirements that Act, which is a modified fraud law, applies only to "dealers" in securities, as defined therein. Whether the Company, in making the proposed offer, and the New York depositary, in acting as an agency in facilitating acceptances of such offer, will be dealers in securities depends upon (1) whether they will be engaged "in the business of trading in securities" in such manner that any of such securities are (2) "sold or offered for sale to the public" in New York.[13]

[12] N. Y. CONS. LAWS (Cahill, 1930) c. 21, art. 23-A.

[13] Section 359-e of the Act, *supra* note 12, provides that "no dealer shall sell or offer for sale to the public within this State, as principal, broker, or agent any securities issued or to be issued" unless certain statements and notices are filed as therein required. This section defines "dealer" to "include every person, partnership, corporation, company, trust or association, except a domestic municipal corporation, who engages directly or through an agent in the business of trading in securities in such manner that as part of such business any of such securities are sold or offered for sale to the public in this State . . .," but provides that "a sale or offer of sale to the public shall not include . . . any sale or offer of sale to any person engaged in the business of acquiring securities for the purpose of resale; any sale or offer of sale to a

If the Company and the depositary will be dealers within such definition, certain statements and notices must be filed under the Act.

It must next be decided whether any affirmative action must be taken by the Company (or by the New York or California depositaries) in compliance with the "Blue Sky" laws of other states in which stockholders reside. If no action need be taken by the Company under a particular state law, *a fortiori* no action need be taken by either of the depositaries. Whether, in any case, action must be taken by a bank acting as a depositary under such or similar circumstances is a question depending upon the scope of the law in question and upon the particular function of the depositary and the manner of its exercise.[14]

Except for possible exemption provisions, compliance with the laws of such other states may, depending upon their scope, require, in some cases, that the Company register as a dealer in securities, in others that the new preferred stock be qualified for sale by the filing of more or less extensive data concerning the Company, in still others that both procedures be followed.[15] Either procedure will probably involve

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banker, to a dealer, or to a corporation, or to any syndicate or group formed for the specific purpose of acquiring such securities for resale to the public directly or through other syndicates or groups, or any sale or offer of sale upon the floor of any exchange to a broker in securities."

An argument may, of course, be made that an issuer in making an offering of securities of a single issue to such stockholders as it may have in New York is neither engaged "in the business of trading in securities" nor offering its securities "to the public in this State." The former phrase is, however, one easily subject to broad construction by anyone desirous of giving fullest effect to the law, and the Department of Law, in promulgating its instructions governing the filing of the "Original Dealer's Statement" states affirmatively that "corporations desiring to sell their own securities direct to the public must also qualify as a dealer by filing Statements described herein." Whether such instruction is intended to cover all direct offerings by an issuer or only those of a continuous and recurring nature (which could more easily be said to constitute the "business of trading in securities") is not apparent. That an offering to stockholders may be a "public offering" (depending entirely on the number of stockholders involved) is clear. See the collection of cases in COMMERCE CLEARING HOUSE, STOCKS AND BONDS LAW SERVICE, Vol. III., par. 2203.03.

[14] The question would be whether the depositary would be "selling" securities. Definitions of "sell," under the various state laws, are customarily very broad. Any attempt to sell, solicitation of a sale or of an offer to buy, and "any act by which a sale is made" usually constitute sales within such definitions (cf. the definition contained in the Illinois Securities Law, ILL. REV. STAT. (1935) c. 32, par. 255, §2(4)). If a depositary merely acts passively as a conduit for depositing stockholders, and has no part in the actual making of the offer, it is obviously not attempting to sell, though it conceivably could be said that the act of receiving deposits, and issuing some evidence thereof, is an "act by which a sale is made." Such reasoning, however, would bring not only depositaries, but also transfer agents, registrars and all other agencies designed to facilitate the issuance of securities within the "Blue Sky" laws, and, so far as the writer knows, no state commission has attempted to assert jurisdiction over such agencies. If a depositary has some connection with the making of the offer (if, for example, it sends out letters to the stockholders apprising them of the offer and advising that deposits may be made with it by those desiring to accept), there is perhaps a more serious question about the applicability of the state laws.

[15] The applicability of many of the statutes will depend upon (1) whether the offer made through the interstate mails will constitute a sale "in" the state in question, despite the fact that (if such is the case) the acceptance completing the contract occurs in the state of residence of the Company, and (2) whether the Company in making such offer through the interstate mails will be engaging "in the business" of dealing in securities in the state in question (a question similar to that discussed in connection with the New York Act in note 13, *supra*). Clearly, an offer communicated in the state, even though not originating therein, is, strictly speaking, an offer *in* the state. It may be contended, however, that offers of this type, where the offeror is beyond the jurisdiction of the state, are not contemplated by the statute.

subjection, limited or unlimited,[16] by the Company to service of process and may make it necessary[17] for the Company to qualify as a foreign corporation under the general corporation laws of one or more states.

A considerable number of the state laws exempt company offers provided they are made exclusively to stockholders and provided no commissions or fees are paid in connection with such offers.[18] Does the underwriting involved in the hypothetical case destroy such exemption, in that it involves a contingent sale to others than stockholders, or in that the underwriters' commissions, to be based in part on stock taken pursuant to the offer to stockholders, will be commissions or fees paid "in connection with" the offer to the stockholders?[19] In many states the new securities will be exempt from qualification requirements if they are "senior" to the listed common stock of the Company.[20] At first blush it would seem obvious that such

[16] In some states subjection to service will be for the purpose of service in all actions or proceedings arising in the state, whereas in others subjection will only be for the purpose of service in actions and proceedings arising out of security transactions.

[17] Necessary, that is, under the "Blue Sky" laws, as a prescribed condition precedent to obtaining a dealer's license or to qualification of the securities. Under ordinary principles, qualification as a foreign corporation would not be required as a condition to engaging in business in interstate commerce.

[18] Thus, §5 of the Illinois Securities Law, *supra* note 14, exempts sales of "(2) Securities of a corporation when sold or distributed by it among its stockholders without the payment of any commission or expenses to agents, solicitors or brokers, and without incurring any liability for any expenses whatsoever, in connection with the distribution thereof."

[19] In a discussion of a similar provision (§3(a)(9)) of the Securities Act of 1933 in Throop and Lane, *Some Problems of Exemption under the Securities Act of 1933*, Part I of this symposium, *supra* note 8, at p. 96 ff.), it has been contended that "the exemption is available only to securities constituting part of an issue which, as a whole, is exchanged in conformity with the requirements of the section." As applied to the hypothetical case under discussion, the applicability of the exemption would, on this basis, depend upon the success of the offering (*i.e.*, upon whether any securities remain for purchase by the underwriters). If this interpretation is correct, an issuer under such circumstances must obviously register the offering at the outset.

An important difference between said §3(a)(9) of the Federal Act and the equivalent provision of the state laws is that the exemption given by the former is, presumably, retained by the security, since the security itself is exempt, whereas the state provisions as a rule only exempt the particular transaction. Such difference may be sufficient to justify the more liberal interpretation that the state provisions will exempt the offering to the stockholders in the hypothetical case as being one complete offering, with no contemporaneous offering to others than stockholders, the later public offering, if any, by the underwriters of any securities not taken by the stockholders being a second distinct transaction not exempt under such provision. The public interest will be amply served by the qualification of any securities sold to the stockholders which may become necessary in any subsequent dealing therein by persons subject to the state laws, and by the qualification effected, to the extent necessary, in connection with such offering as may be made by the underwriters.

[20] This is true in Alabama, Colorado, Florida, Georgia, Idaho, Indiana, Iowa, Kansas, Kentucky, Minnesota, Missouri, Montana, Nebraska, North Dakota, Ohio, Oregon, South Carolina, South Dakota, Texas, Utah and Vermont.

Some of the statutes specify no exchanges, but permit the commission to designate any exchanges whose listing requirements meet certain standards. Others specify certain exchanges and give a discretionary power to the commission to add other exchanges. A typical provision of the latter type is §3(4) of the Ohio Act, OHIO GEN. CODE (Page, 1932 Supp.) §8624-3, as amended, Ohio Laws 1935, p. 265, which exempts

"Any security, whether a preliminary or final security, which, at the time of sale within this state, is listed on the Cincinnati stock exchange, the Cleveland stock exchange, the New York stock exchange or the New York curb market, or any other stock exchange which may be approved of by the division as having listing requirements substantially equivalent to those of any one of the exchanges hereinabove specified, also any security senior to any security so listed; provided this exemption shall apply only so

exemption provisions will be applicable, for a stock preferred as to dividends is clearly senior to a common stock. This conclusion, however, overlooks the conversion privilege attaching to the new preferred stock. Does that privilege mean that in reality two securities (preferred and common stock) are to be offered? If so, the stock exchange exemption will be of little avail.[21] These and other questions will beset a company contemplating such an offer.

"Blue Sky" problems in connection with mergers and consolidations are likewise pressing. If a particular merger or consolidation plan is being promulgated, as is most likely, by the managements of the respective constituent companies, it must first of all be decided whether the solicitation of proxies favoring the merger or consolidation, exercisable at the respective stockholders' meetings, is a solicitation of an offer to buy securities of the proposed resulting or new corporation into which outstanding securities will be converted, within the meaning of the very broad definitions of "sale" contained in most of the state laws. It must also be decided whether the subsequent issue of securities of the resulting or new corporation, upon the conversion into such securities of securities of the constituent companies, or the subsequent issue of certificates representing such new securities, upon surrender of old certificates, will involve a "sale." If a sale within the meaning of any of the state laws will be involved, it may be necessary (in the absence of any applicable exemption) to take action in compliance with such laws. It may, for example, conceivably be necessary for the constituent companies or their managements, and the new or resulting corporation, to register as dealers in securities and for the securities of such corporation to be qualified.

The solicitation of proxies, the issue of new securities and the subsequent distribution of certificates representing such securities, as aforesaid, pursuant to a statutory merger, are not "sales" in any ordinary sense. The Securities and Exchange Commission has recognized this in ruling that such transactions do not require

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long as such security shall be and remain listed, pursuant to official action of such exchange, and not under suspension, and so long as such exchange remains approved under the provisions of this Act."

[21] The laws of some of the states expressly resolve all doubt on this question by providing that a sale of a convertible security shall not be deemed to be a sale of the security into which the former is convertible. Thus, §8581-c3(3) of the Iowa Securities Law, IOWA CODE (1935) c. 391-c, in defining "sale" provides, *inter alia:*

". . . a privilege pertaining to a security giving the holder the privilege to convert such security into another security of the same issuer shall not be deemed a sale, or offer to sell, or option of sale of such other security within the meaning of this definition and such privilege shall not be construed as affecting the status of the security to which such privilege pertains with respect to exemption or registration under the provisions of this chapter. . . ."

Other statutes accomplish the same result by specifying the giving of a conversion right as an exempt transaction. Section 4(6) of the Ohio Securities Act, *supra* note 20, §8624-4(6), for example, exempts

"The giving of any conversion right, subscription right, warrant or option to purchase securities with, or on account of the purchase of, any security which is exempt, or which is the subject matter of an exempt transaction, or which has been registered by description, registered by qualification, or which is the subject matter of a transaction which has been registered by description hereunder."

The laws of other states, however, leave the question unsettled and one must attempt to determine whether, from the definitions of "security" and of "sale" could be conjured up, in the case of convertible securities, a sale of two securities.

registration of the new securities under the Securities Act of 1933.[22] Analytically, the definitions of "sale" contained in most of the state laws would seem to require a similar conclusion.[23] Yet some of the state laws containing such definitions proceed, inconsistently, to *exempt* from qualification requirements securities issued in connection with mergers and consolidations.[24] If such transactions do not involve "sales" of securities, such an exemption would seem not to be necessary, for the existence of an exemption presupposes that, except for the exemption, the transaction exempted would be subject to the act. Moreover, it might well accord with the policy of a particular state to scrutinize mergers and consolidations, in the interest of the stockholders of the constituent corporations residing in such state, as well as transactions involving "sales" of securities in the ordinary sense.

The foregoing serve to illustrate the nature of the "Blue Sky" problems which confront corporations in connection with their direct offerings and related transactions. In any case where a corporation proposes to make an offering of securities (whether of warrants, rights, securities issued upon conversion or ordinary offerings) problems under the various state laws immediately arise. The only practical solution in many cases (where qualification proceedings and other action required by the various state laws, on the assumption they are applicable, would be physically impossible within any reasonable time schedule, if at all) is to take the position that the state laws, other than those of the state of origination of the transaction, are inapplicable because there will be no "offer" made, "sale" consummated or "business"

[22] In the Rules for the Use of Form E-1 (for the registration of securities issued in reorganizations) appears the following:

"Note. The Commission deems no sales to stockholders of a corporation to be involved, within the meaning of the definition quoted in Rule 5(2) [the definition contained in the Securities Act of 1933] where, pursuant to statutory provisions or provisions contained in the certificate of incorporation, there is submitted to the vote of such stockholders a proposal for the transfer of assets of such corporation to another person in consideration of the issuance of securities of such other person, or a plan or agreement for a statutory merger or consolidation, provided the vote of a required favorable majority

(a) will operate, so far as the corporation the stockholders of which are voting is concerned, to authorize the transfer or to effectuate the merger or consolidation (except for the taking of action by the directors of the corporations involved and for compliance with such statutory provisions as the filing of such plan or agreement with the appropriate state authorities), and

(b) will bind all stockholders of such corporation, except to the extent that dissenting stockholders may, under statutory provisions or provisions contained in the certificate of incorporation, be entitled to receive the appraised value of their holdings."

[23] A solicitation, by the management of a corporation, of proxies to vote on a proposed merger or consolidation involving the corporation obviously cannot be an offer of securities, either by the solicitors or by the corporation, because the securities proposed to be issued will not be securities of such corporation but will be securities of the new or surviving corporation and because, in any event, it is the very action of the stockholders in voting upon the merger or consolidation, plus other actions as required by the governing statute or statutes, which will bring into being the new securities. A solicitation, by the management of the proposed surviving corporation of proxies, to vote on a proposed merger is likewise not an offer for the second of such reasons. Upon the favorable vote of the stockholders and the taking of such other action as may be required by law (*viz.*, the execution, filing and recording of the agreement of merger), the old securities are at once converted into the new, and the subsequent issue of new certificates in exchange for outstanding certificates cannot be a "sale" of securities, for the securities are already outstanding.

[24] This is true in Alabama, Florida, Indiana, Iowa, Kansas, Kentucky, Michigan, North Carolina, Oklahoma, South Carolina, Texas, Utah and Vermont.

transacted *within* such states. That the question is not free from doubt creates a most unsatisfactory situation.

(2) *Problems Involved in Underwritings*

A straight underwriting involves, of course, a sale by the issuer to the underwriters and a resale by the underwriters directly to the public or to dealers who resell to the public. Sales by issuers to underwriters ordinarily do not raise manifold "Blue Sky" problems, since such sales are usually either exempt or at most require the issuer to take affirmative "Blue Sky" action in but one or two states.[25]

Sales by underwriters to local dealers raise problems in about a dozen states whose laws do not exempt such sales.[26] Such laws, assuming that there will be involved an "offer" made, a "sale" consummated, or "business" transacted *within* such states, may make desirable either an allotment of all orders received from dealers in such states to one or more of the underwriters who are registered as dealers therein (which involves difficult practical problems) or else, lacking any such underwriters, the exclusion of such dealers from participation in the offering. Public offerings by the underwriters (subject to the question whether, if the offering is of an interstate character, a "local" offering is involved, within the meaning of the state laws) and, in any event, a public offering by the members of the dealer selling group necessitate qualifying the securities, except in so far as they may be exempt, under the laws of all states included in the offering which have either the "inspection" or the "licensing and inspection" type of statute.

Problems also arise in connection with advertising. Underwriters customarily publish, contemporaneously with a public offering, either a newspaper announcement of the offering or the more elaborate "newspaper prospectus," both as permitted by regulations of the Securities and Exchange Commission. While such advertisements do not constitute offers under the Securities Act of 1933, it is conceivable that they are encompassed by the broad definitions of "offer" contained in many of the state laws, and such is the view of certain of the state "Blue Sky" officials.[27] Accordingly, it is customary (whether or not necessary as a matter of law) not to publish any such advertisement in any state whose law would require qualification of the issue prior to a sale in such state unless the issue has been duly qualified. It is also customary to restrict the appearance of underwriters' names in any such advertisement, published in a state whose law requires dealers to be licensed, to those underwriters who are licensed as dealers in such state, unless, pursuant to informal "clearance" with the state officials, the names of non-licensed underwriters may appear therein accompanied by an appropriate "hedge" clause whose purpose is to obviate any possible construction that such advertisement constitutes an offer by

[25] If the issuer is, for example, a California corporation, it must ordinarily obtain a permit from the State Corporation Division pursuant to Section 3 of the Corporate Securities Act, CAL. GEN. LAWS (Deering, 1931) act 3814.

[26] The states of Arizona, Arkansas, California, Colorado, Louisiana, Mississippi, New Hampshire, New Mexico, Oregon, Rhode Island, South Dakota, Tennessee, Wisconsin and, probably, Michigan.

[27] See the discussion in Smith, *supra* note 3, at 1144.

such non-licensed underwriters.[28] In any case, the publication of such an advertisement in a newspaper of wide circulation raises certain theoretical problems, even though no violation of the law of the state of publication or primary circulation is involved, arising out of the fact that such newspaper may be circulated in states in which either the issue is not qualified or the underwriters whose names appear therein are not licensed as dealers.[29]

In short, every underwriting involves as a necessary step in the preparation for a public offering an examination of the "Blue Sky" laws of all states proposed to be included in the offering. Action must be taken to qualify the securities and otherwise under such laws to the extent necessary. Local counsel must in some instances be employed to expedite the process of qualification. Practical difficulties may be encountered in effecting qualification on or before the effective date of the federal registration statement. Occasionally, some prohibitory provision of a state statute, or the arbitrary position taken by a state official, or the refusal of the issuer to comply with onerous provisions of a state statute or regulation, may make qualification impossible.

(3) *Sanctions Imposed by State Laws*

Practically all the state laws provide for punishment by fine or imprisonment, or both, for violations of their provisions. Many also provide, in effect, either that any contracts made in violation thereof shall be voidable, at the election of the purchaser, or that purchasers of any securities sold in violation thereof shall be entitled to recover the purchase price from any person who participated in such violation.[30]

[28] Such clearances, of course, give little, if any, legal protection, except in cases where they are based upon an official interpretive regulation of the state commission, adopted pursuant to statutory authority. They should, however, protect from criminal liability where an intent to violate the law is an element of the crime. They are also of practical utility in indicating that proceedings based on such advertisements are not likely to be initiated by the officials who have expressed their approval.

A typical clause of this sort reads as follows:

"This advertisement is not and is under no circumstances to be construed as an offer of these Bonds for sale or as a solicitation of an offer to buy any of such Bonds. The offering is made only by the Prospectus. This advertisement is published on behalf of only those of the undersigned who are registered dealers in securities in this state.

"Copies of the Prospectus may be obtained only from such of the undersigned as are registered dealers in securities in this state."

The language used in the "hedge" clause varies in certain of the states to meet the requirements of the officials of such states. In Colorado and Missouri it is customary to indicate by the use of an asterisk which of the undersigned underwriters are registered as dealers in such states. The Pennsylvania officials are adamant in their view that the names of non-licensed underwriters may not appear in any such advertisement without violation of the Pennsylvania Securities Act.

[29] Such theoretical problems arise, of course, by virtue of the possibility that the circulation of such an advertisement in such states constitutes an "offer" of the securities advertised therein in violation of the laws of such states. The answer may be made that since, as a practical matter, a newspaper is primarily an agency of communication in the state of its publication, advertisers should not be held to account to other states in which, incidentally, such newspaper may be circulated. The problem becomes more acute in connection with advertisements published in magazines of wide national circulation. Attempts have been made to incorporate in such advertisements general "hedge" clauses which seek to establish an immunity for such advertisements from the laws of any state in which either the issue is not qualified or any of the underwriters whose names appear therein are not licensed. It is obvious that such a procedure must be futile, at least so far as issue qualificaton requirements are concerned, since the effect of such a clause is to attempt to deny that the advertisement is in fact an advertisement.

[30] Section 19 of the Indiana Securities Law, IND. STAT. (Burns, 1933) tit. 25-819, for example, provides

The California Act goes so far as to provide that securities sold in violation of the Act shall be void.[31]

Some courts have construed such remedial provisions as being applicable only where the contract or sale in question was made locally, on the theory that the validity of a contract is determined by the law of the place where the contract was made.[32] One court, at least, has implied that the contract or sale is voidable irrespective of where it was actually made, provided some act leading up thereto was done in violation of the law providing the remedy.[33]

It might be difficult, of course, as a practical matter, to enforce either the penal or remedial provision of a state law against a nonresident violator, since even the so-called "remedial" provisions might be considered as penal in nature and enforcement thereof refused by the courts of another state on well-recognized principles. Nevertheless, the sanctions are such as to give pause to issuers and underwriters concerned with large offerings involving many states. The situation is such as to suggest that consideration be given to the question whether improvements may not be made, without sacrifice of the public interest, to remove or lighten the burden of compliance with the state laws in the case of securities registered under the Securities Act of 1933 and, accordingly, to reduce the risks incurred in connection with certain innocuous practises, such as advertising in the manner referred to above.

CORRELATION OF STATE LAWS WITH THE SECURITIES ACT OF 1933

(1) *Action by Congress to Remove from the States Jurisdiction over Interstate Transactions*

In view of the extensive requirements made by the Securities Act of 1933, issuers and underwriters who are also faced with vexing state requirements may plausibly feel that Congress should take action, under its paramount power, to withdraw from the states such concurrent jurisdiction as they may now have to legislate concerning interstate transactions. As heretofore noted, that Act (and the Securities Exchange Act of 1934) now expressly leave the pre-existing jurisdiction of the states unimpaired.[34] The result of such action would be to establish an immunity from state laws for transactions in securities of a clearly interstate character. It would not be

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as follows: "Every sale or contract for sale made in violation of any of the provisions of this act shall be voidable at the election of the purchaser and the person making such sale or contract for sale and every officer, director or agent of or for such seller who shall have participated or aided in any way in making such sale shall be jointly and severally liable to such purchaser in an action at law in any court of competent jurisdiction upon tender to the seller of the securities sold or of the contract made for the full amount paid by such purchaser. . . ."

[31] Corporate Securities Act, *supra* note 25, §16.

[32] See Brocalsa Chemical Co. v. Langsenkamp, 32 F. (2d) 725 (C. C. A. 6th, 1929).

[33] See Bartlett v. Doherty, 10 F. Supp. 465 (D. N. H. 1935). In that case an unlicensed agent of a licensed New Hampshire dealer had, the court said, made "sales" *in* New Hampshire, subject, however, to "confirmation" by the Boston or New York office of the dealer. If these actually were contracts of sale upon a condition subsequent, the case is not, on its facts, inconsistent with Brocalsa Chemical Co. v. Langsenkamp, *supra* note 32. If, however, the contracts did not come into being until "confirmation," the decision is opposed to that of the *Brocalsa Chemical Co.* case. In any event, the gist of the court's reasoning is that technical devices should not be available to escape the application of state laws.

[34] See note 5, *supra*.

necessary, in respect of such transactions, either that the securities involved be qualified under the laws of the various states or that the offerors be registered as dealers in securities in such states. Would this involve any sacrifice of public interest? The answer, of course, depends upon the extent to which the public interest is adequately served by the federal law.

It would seem, *a priori,* that the public interest so far as interstate transactions are concerned, should as a whole be better served by the Securities Act of 1933 than by the heterogeneity of state laws, for otherwise there would have been no reason for federal legislation. The theory is being confirmed by the operation of the Act. The registration and prospectus requirements of the Act make mandatory a much more complete disclosure of essential facts concerning offerings of securities than, in general, do the qualification requirements of the state laws. As a result, the investor now unquestionably has more information at hand on which to base his judgment than was ordinarily available theretofore; moreover, such information is presented to him, as required by the Act, directly in the form of a prospectus conforming to certain established standards, whereas the information furnished under the state laws was usually available only at the state capitol among the public records. The remedies afforded by the Act to purchasers of securities sold in violation of the provisions of the Act are considerably more extensive than those similarly afforded by the various state laws. The painstaking thoroughness with which registration statements filed with the Securities and Exchange Commission are customarily prepared, at least in connection with large issues, is persuasive evidence of the effective protection given to the investor by the Securities Act of 1933 in respect of transactions subject to its provisions.

In only two respects may it be asserted that some, at least, of the state laws more adequately serve the public interest than does the Federal Act. To the extent that any of the state laws are based on a different theory than the Federal Act, or cover transactions not covered by the Act, it may, of course, be contended that the Act is not an adequate substitute for state legislation, so far as those states are concerned.

As heretofore noted, the theory of the Securities Act of 1933 is that the proper governmental function in connection with transactions in securities is to prevent fraud by requiring a disclosure to prospective purchasers of all material facts relative to an offering. As also previously noted, some states apparently seek to go further and prevent the sale altogether of certain securities (either on the theory they are unsound, or are *per se* fraudulent) and the sale of any securities on terms not considered fair, the determination in some cases being made by statute, in others by administrative officials pursuant to statutory authority. Whether the different theory underlying the laws of such states should be regarded as sufficient to justify the retention of state jurisdiction over interstate transactions is a question which may only be resolved by deciding whether the degree of paternalism manifested by such laws is justified either in theory or by its results. Whatever may be the theoretical justification for such a policy, it may be seriously questioned whether, as a practical

matter, such laws do in fact result in greater protection to the purchaser than is afforded by the Securities Act of 1933.

That some of the state laws are applicable to a larger number of transactions than is the Securities Act of 1933 is brought out by a comparison of the exemptions provided under the Federal Act and under the various state laws. For example, Section 3(a)(1) of the Act exempts from the registration and prospectus requirements of the Act

"Any security which, prior to or within sixty days after enactment of this title, has been sold or disposed of by the issuer or bona fide offered to the public, but this exemption shall not apply to any new offering of any such security by an issuer or underwriter subsequent to such sixty days."

Again, Section 4(1) of the Act exempts from such requirements

"transactions by any person other than an issuer, underwriter, or dealer; transactions by an issuer not involving any public offering; or transactions by a dealer (including an underwriter no longer acting as an underwriter in respect of the security involved in such transactions), except transactions within one year after the *first* date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter (excluding in the computation of such year any time during which a stop order issued under Section 8 is in effect as to the security), and except transactions as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter."

Most state laws, on the other hand, apply to any offering of non-exempt securities *at any time* by an issuer or dealer to a member of the public. Such differences in scope likewise involve a question of policy. Even assuming, however, that the coverage of such state laws should be retained in so far as not concurrently provided for under the Federal Act, duplicative requirements of state laws might appropriately be eliminated, and this could most easily be accomplished by Congressional action to the effect that, so far as transactions comprehended by the Federal Act are concerned, the state laws shall be inapplicable.

(2) *Amendment of the State Laws to Take Cognizance of Registration under Securities Act of 1933*

As an alternative, the state laws themselves could be amended either to exempt securities registered under the Securities Act of 1933 or, at least, to make qualification of such securities possible by some very simple procedure. Amendments of this nature would eliminate onerous duplicative state qualification requirements, but would leave operative state dealer-licensing provisions.

While a state which seeks to do more than require a factual disclosure could not reasonably be expected to *exempt* securities registered under the Federal Act, such state could consistently permit the qualification of securities by the filing of a simple form of application to which could be annexed a copy of the federal prospectus in satisfaction of informational requirements. The information contained in the prospectus should normally be sufficient to enable the state administrative body to determine whether the offering is one which is permissible under the state law.

If, on the other hand, the policy of the state is to prevent fraud through enforced disclosure of material facts concerning offerings, no reason is apparent why such state should not, consistently therewith, take cognizance of the fact that an identical policy underlies the Securities Act of 1933, and either exempt securities registered under the Act or, as a minimum gesture of coöperation, permit qualification under the state law by the simple means suggested above.

Neither proposal involves anything radical or essentially new in principle. Many of the state laws now exempt securities issued under the supervision of public utilities commissions and securities listed on certain recognized stock exchanges. The principle of allowing "credit" for action taken by issuers pursuant to the requirements of recognized public or quasi-public bodies is thus established. It is reasonable to expect that the states should to the same degree rely upon the requirements of, and the standards set by, the Securities and Exchange Commission. It may be noted that one state, at least, has taken a step in this direction. The new South Carolina Act, effective October 28, 1936, permits securities of "seasoned" corporations registered with the Securities and Exchange Commission (on Form A-2) to be qualified by means of a simple process of "notification."[35]

One further feature should be incorporated in any such amendment of a state law, based on a recognition of the practice obtaining under the Securities Act of 1933. Registration statements under the Act do not become "effective" until the twentieth day after their filing. This twenty day period is designed to be a period during which prospective purchasers may be acquainted with the facts concerning the securities without being subjected to selling pressure and without, in fact, any offering being made. It is important, therefore, that it should be possible to distribute information concerning securities preliminarily without having such distribution constitute an offer under the state laws; it is important, moreover, that it should be possible to make an offering in the various states immediately upon the federal registration statement's becoming effective. Both objectives may be accomplished if amendments of state laws, along the lines suggested above, permitting the qualification of securities by the filing of a simple form of application together with a copy of the federal prospectus, also permit such qualification to become effective by the use of a preliminary and tentative form of the prospectus, subject, however, to the filing of a definitive prospectus upon or as soon as possible after the effective date of the federal registration statement.

Other suggestions may be made for improving the state laws, in the interest of uniformity and practicable workability. These are, however, beyond the scope of the present discussion, since they are unrelated to the Federal Acts. It is enough at present to have indicated briefly some of the problems arising under the state laws and to have suggested some means of removing doubts which now exist as to the applicability of the state laws to certain transactions, and of lightening the burden of compliance with such laws, in connection with transactions already subjected to regulation under the Securities Act of 1933.

[35] S. C. Laws 1936, H. B. 1807, §7(2).

THE SECURITIES EXCHANGE ACT AS SUPPLEMENTARY OF THE SECURITIES ACT

JOHN HANNA*

The broad purpose of the Securities Act of 1933 is to protect the buyer of a newly issued security by requiring a fair disclosure of material facts and by penalizing the failure to furnish them in connection with the sale of the security through the use of the mails or of the instrumentalities of interstate commerce.[1] In addition, Section 17 of the Securities Act makes unlawful the use of the mails or the instrumentalities of interstate commerce to defraud buyers of securities whether newly issued or not.[2]

The Securities Act itself contains no provisions requiring issuers of securities registered under it to supply investors with current information about these securities. It is not concerned in any way with dealings in securities already issued nor, except to a limited extent, with dealings in securities issued in accordance with its provisions. It is obvious that many factors besides the information available at the time of registration may have a bearing upon the attractiveness of a security to a purchaser. The information provided in the registration statement becomes obsolete

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[1] The Securities and Exchange Commission in its Second Annual Report states, at p. 1, the purposes of the Securities Act of 1933 and the Securities Exchange Act of 1934 as follows:

"The purposes of the Securities Act of 1933 as outlined in the Report of the Committee on Banking and Currency are to prevent exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion; to bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power.

"The objectives sought in the passage of the Securities Exchange Act of 1934 were threefold, viz., to prevent the excessive use of credit to finance speculation in securities; to see to it that the market places in which securities are purchased and sold, such as the stock exchanges and the so-called over-the-counter markets, are purged of the abuses which had crept into them; and to make available to the average investor honest and reliable information sufficiently complete to acquaint him with the current business conditions of the company, the securities of which he may desire to buy or sell."

See Douglas and Bates, *The Federal Securities Act of 1933* (1933) 43 YALE L. J. 171; Tracy and MacChesney, *Securities Exchange Act of 1934* (1934) 32 MICH. L. REV. 1025.

[2] Section 17 is an important supplement to state blue-sky laws. See Smith, *State "Blue-Sky" Laws and the Federal Securities Act* (1936) 34 MICH. L. REV. 1135-1166.

in a comparatively brief period. Moreover, whatever the intrinsic merits of a security its desirability for the purpose of investment and speculation is affected by an actual and apparent demand for it. If the purchaser is induced to buy for $200 a security fairly worth $100 the effect upon his solvency may be substantially the same as if he bought for $100 a security worth nothing. While the Securities Exchange Act of 1934 has other purposes, notably the regulation of credit used in security dealings, one of its primary objects is to supplement the protection given the investor by the Securities Act.[3]

The Securities Exchange Act of 1934 supplements the Security Act in two principal ways:[4] (1) It makes available reliable information about the current business conditions of the issuers of what are on the whole the most important securities bought and sold in the United States;[5] (2) It prohibits practices tending to create fictitious values for securities and gives the Securities and Exchange Commission broad powers over the trading in securities.

[3] The editor of this symposium has requested as the conclusion of this symposium a brief statement of the extent to which the Securities and Exchange Act confirms and supplements the Securities Act. No attempt is here made to indicate various differences of detail between corresponding sections of the two acts or to discuss purposes of the Exchange Act which have no direct bearing on the purposes of the Securities Act. These can be left appropriately to more comprehensive discussions of the Exchange Act.

[4] The Securities Exchange Act of 1934 included as a rider significant amendments to the Securities Act of 1933. These amendments are not dealt with here. They have been mentioned in other articles in this symposium and are here mentioned as a part of the Securities Act rather than of the Securities Exchange Act. See Hanna, *The Securities Exchange Act of 1934* (1934) 23 CALIF. L. REV. 1.

[5] The importance ascribed to the features of the Act carrying forward the publicity features of the Securities Act is shown in the following extract from H. R. REP. No. 1363, 73d Cong., 2d Sess., quoted from C. C. H., STOCK EXCHANGE REGULATION SERVICE, par. 2105.02, pp. 1016-1018: "No investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. The idea of a free and open market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value. There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy. The disclosure of information materially important to investors may not instantaneously be reflected in market value, but despite the intricacies of security values, truth does find relatively quick acceptance on the market. That is why in many cases it is so carefully guarded. Delayed, inaccurate, and misleading reports are the tools of the unconscionable market operator and the recreant corporate official who speculate on inside information. Despite the tug of conflicting interests and the influence of powerful groups, responsible officials of the leading exchanges have unqualifiedly recognized in theory at least the vital importance of true and accurate corporate reporting as an essential cog in the proper functioning of the public exchanges. Their efforts to bring about more adequate and prompt publicity have been handicapped by the lack of legal power and by the failure of certain banking and business groups to appreciate that a business that gathers its capital from the investing public has not the same right to secrecy as a small privately owned and managed business. It is only a few decades since men believed that the disclosure of a balance sheet was a disclosure of a trade secret. Today few people would admit the right of any company to solicit public funds without the disclosure of a balance sheet. . . .

"The reporting provisions of the proposed legislation are a very modest beginning to afford that long-denied aid to the exchanges in the way of securing proper information for the investor. The provisions carefully guard against the disclosure of trade secrets or processes. But the idea that a fair report of corporate assets and profits gives unfair advantage to competitors is no longer seriously entertained by any modern business man. The realistic corporate executive knows that his alert competitors have a pretty good notion of what his business is and if he is unable to compete with them it is because he is hope-

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The more ardent believers in public control of business favor giving governmental agencies a comprehensive control over all phases of investment and speculation. Considerable progress has been made in that direction by the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934. The responsibilities of the Securities and Exchange Commission and of the Federal Reserve Board under that Act are too varied to be discussed within the bounds of a single article. Since what is here attempted is a statement of the extent in which the Exchange Act supplements the purposes of the Securities Act, most of this discussion must be directed to the publicity features of the Exchange Act.

Prior to the passage of the Exchange Act the investor and speculator in corporate securities found his chief protection in the listing requirements of the New York Stock Exchange. Some corporations, notably the United States Steel Corporation, were generous in their disclosures to stockholders and the general public. Many corporations, however, regarded figures about corporate business as the property of insiders, and gave out as little information as possible.

Listing requirements on stock exchanges have for their purpose not only a certain assurance of the genuineness of the securities listed and of a free and open market, but also the providing of relevant information about the securities and the issuers. The New York Stock Exchange, occasionally with the sharp opposition of corporation executives, accomplished much to make corporate information available to the public. Listing requirements have become progressively more rigorous in recent years. At the time of the Senate investigation of the Stock Exchange in 1932, the Stock Exchange required an application for listing to be presented to the Exchange for consideration by the Committee on Stock List.[6] The application was required to state much detailed information about the issuer, its capitalization, the privileges accruing to its various security issues, its subsidiary and controlled companies, its property and current business and to be accompanied by financial statements, including balance sheets and income accounts. Copies of charters and other documents, mostly bearing directly upon the listing application, were required to be filed with the application but in general the requirements of the filing of copies

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lessly behind in the keen competitive struggle. The reporting provisions of the legislation have been approved by such conservative investment services as Moody's and Standard Statistics and, despite the wild fears spread throughout the country by powerful lobbyists against this bill, intelligent business men recognize that general knowledge of business facts will only help and cannot hurt them. The possession of these facts has for a number of years been the exclusive perquisite of powerful banking and industrial groups. Making these facts generally, available will be of material benefit and guidance to business as a whole."

[6] The New York Stock Exchange listing requirements in 1932 may be found in Exhibit No. 28, p. 76 *et seq.*, Appendix to Parts 1, 2, 3, U. S. Senate. Banking and Currency Committee, Hearings on Stock Exchange Practices, S. Res. 84, 72d Congress, 1st Sess. See, for a general discussion of New York Stock Exchange listing requirements, TWENTIETH CENTURY FUND, INC., THE SECURITY MARKETS (1935) 235-237, 592-609. The stock listing requirements of all the national securities exchanges are found in the Supplement to the C. C. H., STOCK EXCHANGE REGULATION SERVICE. The New York Stock Exchange requirements are set out in pp. 8215-8235.

of documents were much less severe than under either the Securities Act or the Exchange Act.

A most important part of the application for stock listing consisted in a number of agreements which had to be made with the Exchange as a condition of listing. These agreements, among others, were to notify the Exchange of changes in the nature of the business of the issuer, to furnish annual balance sheets and income statements to stockholders, and to publish periodical reports of earnings as agreed with the Stock List Committee. These agreements were numerous and detailed and resulted in a great improvement in the amount and nature of the information available to stockholders. Since 1934 the Stock Exchange has definitely required that financial statements contained in annual reports of corporations shall be audited by independent public accountants and shall be accompanied by the certificate of the accountants. The Exchange so far as it deems it feasible, requires quarterly earnings reports. Some of the stock listing requirements have been adopted since certain securities were listed but the Exchange endeavors so far as possible to induce issuers of listed securities to comply with later policies even when the issuers are not bound by agreement to do so.

The Committee on the Stock List has also worked informally, both in cooperation with the American Institute of Accountants and otherwise, for the improvement of corporate reports. For example, corporations have been urged to distinguish between capital and earned surplus and to disclose the nature of "other income" where such an item appears in an earnings report.

The Exchange Act in its registration requirements for securities that are the subject of trading on national securities exchanges provides a supplement and not a substitution for the listing rules of the exchanges. National securities exchanges themselves must be registered as a result of the prohibition in Section 5 of the use of the mails or of the instrumentalities of interstate commerce by a dealer, broker, or exchange for the purpose of employing the facilities of a national securities exchange unless the exchange is registered. Section 6 provides for the registration of exchanges. Section 12 requires registration of securities listed on exchanges or admitted to unlisted trading privileges.[7] Section 13 provides for periodical and other reports designed to keep reasonably current information provided by registration under Section 12.[8] The sections requiring registration of securities and periodical

[7] The Commission has prescribed in its Forms 10 and 23, inclusive, forms of application for permanent registration of securities by various types of issuers.

[8] Section 13 is potentially one of the most significant sections of the Act, particularly in respect to its effect on the individual investor. The registrants under Section 12 are by Section 13 required to keep current the information and documents filed under Section 12, to furnish annual reports, and if the Commission so requires, quarterly reports as well, and to conform to the Commission's directions as to form and contents of reports, and even as to accounting methods. The Commission has prescribed the form of annual reports in its Forms 10K to 21K, inclusive, Securities Exchange Act Release No. 1005, Jan. 6, 1937. See, as to current reports, S. E. C. Rule KA7, adopted in Securities Exchange Act Release No. 925, effective November 11, 1936.

Annual reports must be filed not more than one hundred and twenty days after the close of each fiscal year. Special forms are provided relating to securities of fixed investment trusts, voting trust

reports are supplemented by Section 16. This section imposes upon a beneficial owner of more than ten per cent of any class of a registered equity security and upon each director and officer the obligation to file a statement of his holdings and report any changes at the end of each calendar month. If any such person buys an equity security and sells it within six months at a profit, or sells or buys it back at a profit within six months, the issuer may recover the profit. Short sales by officers, directors and ten-per-cent stockholders are forbidden. The purpose of the section is to prevent insiders from profiting by dealings in securities on the basis of information not available generally to the stockholders. The provisions regarding officers, directors and ten-per-cent stockholders, while easy enough to apply in normal situations, present difficult problems of both interpretation and application in the intricate variety of circumstances in which security dealings actually occur.[9]

The procedure for registration of a security is for the issuer to file an application to an exchange and to file such duplicate originals with the Commission as the latter may require, covering such information as the Commission may stipulate in respect to items listed in Section 12(b). These items are as follows:

(A) the organization, financial structure and nature of the business;

(B) the terms, position, rights, and privileges of the different classes of securities outstanding;

(C) the terms on which their securities are to be, and during the preceding three years have been, offered to the public or otherwise;

(D) the directors, officers, and underwriters, and each security holder of record holding more than 10 per centum of any class of any equity security of the issuer (other than an exempted security), their remuneration and their interests in the securities of, and their material contracts with, the issuer and any person directly or indirectly controlling or controlled by, or under direct or indirect common control with, the issuer;

(E) remuneration to others than directors and officers exceeding $20,000 per annum;

(F) bonus and profit-sharing arrangements;

(G) management and service contracts;

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certificates, and certificates of deposit issued by a committee. C. C. H., STOCK EXCHANGE REGULATION SERVICE, par. 8530, p. 6526.

Current reports must be filed in the first ten days of the month following the month in which occurs one of the following events:

"1. Material amendments of exhibits previously filed.
2. The execution of new voting trust agreements and certain other instruments.
3. Substantial restatements of the capital shares account.
4. The issuance of any new class of securities, or an increase or decrease of more than 5% in the amount of any class of securities outstanding.
5. Under certain circumstances, the granting by the registrant of options to purchase any of its equity securities, or the extension or exercise of such options.
6. A person's becoming or ceasing to be a parent or subsidiary of the registrant.
7. Substantial revaluation of the registrant's assets.
8. Substantial withdrawals or substitutions of property securing any registered securities."

C. C. H., STOCK EXCHANGE REGULATION SERVICE, par. 8519, p. 6516.

The Commission has prescribed two Uniform Systems of Accounts, one for Public Utility Holding Companies, and one for Mutual Service Companies and Subsidiary Service Companies. The regulations prescribing these systems were issued, however, not under §13 of the Exchange Act, but under §13 of Public Utility Holding Company Act of 1935.

[9] See Seligman, *Problems Under the Securities Exchange Act* (1934) 21 VA. L. REV. 1.

(H) options existing or to be created in respect of their securities;

(I) balance sheets for not more than the three preceding fiscal years, certified if required by the rules and regulations of the Commission by independent public accountants;

(J) profit and loss statements for not more than the three preceding fiscal years, certified if required by the rules and regulations of the Commission by independent public accountants; and

(K) any further financial statements which the Commission may deem necessary or appropriate for the protection of investors.

The issuer must also file such copies of articles of incorporation, by-laws, trust indentures, underwriting arrangements, voting trust agreements and other similar documents, as the Commission may require as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security.

It is a condition of registration that the exchange authorities certify to the Commission that the security has been approved by the exchange for listing and registration. Registration becomes effective thirty days after the receipt of such certification by the Commission or in such shorter time as the Commission may determine. The registration requirements of Section 12 are generally similar to the registration requirements of the Securities Act as set forth in Schedule A. Both registration requirements may be modified or especially may be enlarged by the Commission. Schedule A, however, contains more detailed provisions relating to underwriters and promoters.[10] It also requires the filing of copies of such documents as indentures, whereas copies of such documents need be filed under the Exchange Act only if the Commission determines they should be filed in the public interest.[11] Both registration statements differ from the usual stock exchange listing requirements in their demand for disclosure of the stock interest and remuneration of officers, directors, ten per cent stockholders and others. On this item the Exchange Act is more drastic than the Securities Act. Under the former the officers, directors and ten per cent stockholders must be named and their remuneration stated, as well as the remuneration of others if more than $20,000 a year.[12] Under the Securities Act, the remuneration to officers and other persons, except directors, may be stated without allocation to individuals unless they receive an annual compensation of $25,000 or more.[13]

Exemptions from registration under the Exchange Act are somewhat narrower than under the Securities Act. Some securities such as insurance policies, receivers' certificates and securities of building and loan associations, which need not be registered under the Securities Act, are not included as exempt under the Exchange Act, perhaps because they are not likely to be listed on an exchange. Reorganization securities and securities of interstate common carriers, subject to Section 20 of the Interstate Commerce Act, are exempt from registration under the Securities Act but must be registered under the Exchange Act, presumably because of the continuing

[10] Securities Act, Sched. A, (6), (10), (17), (18), (20), (21), (22).
[11] *Id.*, Sched. A, (28), (30), (31), (32).
[12] Securities Exchange Act, §12(b)(1)(D)(E); §13.
[13] Securities Act, Sched. A (14).

publicity features of the latter Act. The principal exempt securities under both Acts are the bonds of the United States, the states and their subdivisions.[14] It is rather surprising that under the Securities Act but not under the Exchange Act, certificates of deposit for exempt securities are not exempt from registration. Because of the size of the administrative problem confronting the Commission, the Act in effect granted to listed securities a temporary exemption from registration by providing that the Commission was authorized to permit securities listed on an exchange at the time the registration of the exchange became effective to be registered until July 1, 1935 without complying with the registration requirements of Section 12. The Commission duly allowed the period of grace. In accordance with the provisions of the Act the full registration requirements are now in effect.

If a corporation has registered a security under the Securities Act it should have little difficulty in complying with listing and registration requirements under the Exchange Act. The collection and arrangement of information in the form required by the Commission will also facilitate the preparation of annual and periodical reports. Similarly if a going concern, which has registered its securities under the Exchange Act or has published the annual or periodical reports in the form approved by the Commission, wishes to register a new security issue under the Securities Act, its counsel, accountants and officers will find themselves with considerable material for the preparation of the new documents. The somewhat greater severity of the registration requirements under the Securities Act and the tendency of the Commission and its staff to scrutinize applications for registration under the Securities Act somewhat more carefully than applications under the Exchange Act, indicates that the corporation which has successfully registered a security under the Securities Act, is somewhat better prepared for subsequent dealings with the Commission than one which has merely registered a security on a national securities exchange. It seems, however, that such differences are likely to diminish rather than to increase.

The Commission in administering the Exchange Act has an opportunity to enable it to obtain information which may afford a basis for proceedings to enforce compliance with the Securities Act. An interesting instance of this procedure is found in connection with a recent issue of bonds of the Brooklyn Manhattan Transit Corporation.[15] In 1934 these bonds were sold to four investment banking houses. No registration statement was filed under the Securities Act. The bonds were duly listed on the New York Stock Exchange. The investment bankers then resold the bonds. The Corporation applied for registration of these bonds under the Exchange Act. The Commission refused to allow the registration pending a hearing, which was held October 3 and 4, 1934. The Commission's inquiries disclosed that at least $524,000 principal amount of the bonds were carried through the mails or in interstate commerce between June 11, 1934, the earliest delivery date of the bonds, and September 15, 1934. The Commission also regarded the four investment banking

[14] *Id.*, §3(a); Securities Exchange Act, §3(a).

[15] Securities Exchange Act Release No. 261, June 6, 1935, with opinion dated June 4, 1935.

houses as underwriters within the terms of the Securities Act. The Commission took the position that the bonds should have been registered under the Securities Act and that, since this registration had not occurred, they were not entitled to registration under the Exchange Act and in consequence not entitled to trading privileges on a national securities exchange. The Commission thus held that it might refuse to make available the facilities of national securities exchanges to securities which should have been, and were not, registered under the Securities Act. In the actual case the Corporation, upon learning the attitude of the Commission, registered the bonds under the Securities Act, and when this registration became effective the Commission also allowed registration under the Exchange Act and the bonds were restored to trading privileges on the New York Stock Exchange.

In addition to listed securities it has been the practice of exchanges to permit trading in certain unlisted securities. The Exchange Act as originally passed allowed the Commission to continue until June 1, 1936 unlisted trading privileges to securities which had such privileges on any exchange prior to March 1, 1934.[16] An amendment passed in 1936,[17] allows an exchange, subject to the Commission's regulations, to continue unlisted privileges to those securities enjoying the privilege prior to March 1, 1934, to those listed on other exchanges and to other securities, where the issuer has filed with the Commission registration statements and periodic reports. It is provided further that any security granted unlisted trading privileges is to be deemed registered on a national securities exchange and thus subject to the laws and regulations applicable to registered securities and their issuers.

Besides the securities in the listed and unlisted trading departments of the national securities exchanges, and the securities of small corporations in which no particular market is maintained, other securities of considerable importance are the subject of trading in what is known as the over-the-counter market. It is the practice for some brokerage or investment house to announce itself as making a market for certain securities not dealt in on the exchanges. It gathers lists of persons who are likely to wish to buy or sell these securities. The financial community understands that purchases and sales of certain stocks and bonds may most conveniently be made through certain houses. These houses also are generally ready to quote bid and asked prices. The Exchange Act recognizes that if it applied only to trading on exchanges, the over-the-counter market might afford an opportunity for evading the law. The Exchange Act originally made no attempt to prescribe rules for the regulation of over-the-counter markets, merely giving the Commission in Section 15 broad regulatory authority and a direction for study and report. In 1936 following the Commission's report and recommendation Section 5 was amended and amplified.[18]

[16] Securities Exchange Act, §12(f).

[17] Pub. No. 621, 74th Cong. 2d Sess., approved May 27, 1936.

[18] *Ibid.* The registration requirements were effective August 26, 1936. Besides §§12 and 15, the Act also amended in minor particulars Sections 17(a), 18(a), 20(c), 21(f), and 32.

The Exchange Act now requires all brokers and dealers except those effecting transactions solely on registered exchanges, to be registered with the Commission, unless their business is exclusively intrastate or restricted to trading in exempt securities or commercial paper.[19] Since the Commission has the broadest power to determine the information it may require from brokers, it is obvious that the Commission can thus obtain perhaps all the information it needs about the securities for which the registrant may be making a market. The new section also contains the definite stipulation[20] that every registration statement under the Securities Act, filed more than 90 days after May 27, 1936, shall contain an undertaking by the issuer to file with the Commission such supplementary information and periodic reports as the Commission may require from issuers of securities registered on a national securities exchange. Such an undertaking becomes operative only if the aggregate offering price of the issue of securities is $2,000,000 or more. The duty assumed by this undertaking is suspended if such security or any other security of the issuer is registered on a national securities exchange so that it automatically becomes subject to the duties imposed upon issuers of registered securities. The duty is also suspended if the aggregate value of all outstanding securities of the class to which such issue belongs is reduced to less than $1,000,000.

Section 11 of the Securities Act imposes civil liabilities for material inaccuracies or material omissions in a registration statement. Until the Securities Act was amended by the rider attached to the Exchange Act of 1934, liability under Section 11 was based on a theory of rescission with the abolition of the requirement of privity. Under the original act there was no burden on a plaintiff to prove reliance, causation and scienter. The few defenses available to the many categories of persons upon whom civil liability was imposed by the Securities Act, included failure to establish that the statement in question was untrue, that it related to opinion and not fact, and that it was immaterial.[21]

Since 1934, Section 11 is not founded on a rescission theory. The plaintiff must now show that he has relied on the misstatement provided that before the plaintiff acquired the security, the issuer published an earnings statement covering at least twelve months after the effective date of the registration statement. Reliance may be proved, however, without proof that the plaintiff read the registration statement. Another change made by the 1934 amendments was to allow the defendant to show a lack of causal connection between the untruth and the plaintiff's loss. Finally this amendment established definite rules for the measurement of damages. The suit "may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought

[19] The form of the requirement is a prohibition of the use of the mails or the instrumentalities of interstate commerce to effect certain transactions in securities.

[20] Securities Exchange Act, §15(d), as amended by Pub. No. 621, *supra* note 17.

[21] Comment, *Civil Liability for Misstatements in Documents Filed Under Securities Act and Securities Exchange Act* (1935) 44 YALE L. J. 456.

or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof at the time such suit was brought."

Even as amended, the civil liability provisions of the Securities Act remain more rigorous than those of the Exchange Act. Civil liability under the latter may arise from misleading statements in a variety of documents. These include registration statements for securities, periodical reports by issuers of such securities, statements filed by directors, officers or ten per cent stockholders and documents which the Commission may require in connection with unlisted securities or securities on over-the-counter markets. A cause of action is given by Section 18(a) against "any person who shall make or cause to be made any statements in any application, report or document filed "under the Act or its regulations, if the statement was "at the time and in the light of the circumstances false and misleading with respect to any material fact." This liability is in favor of "any person (not knowing that such statement was false or misleading) who in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement." The defense is open to the person sued that he acted in good faith and had no knowledge that such statement was false or misleading. It will be noted that contrary to the provisions in Section 11 of the Securities Act the plaintiff must prove that he relied on the misstatement without any exception from this requirement during a period immediately after the publication of the untrue statement. Some persons have argued that the Act in requiring reliance is unduly generous to those responsible for misleading statements. Such statements may influence investment services and other advisers to such an extent as may affect the market and so cause injury to buyers or sellers who are themselves unaware of the misleading statements.

The Exchange Act, it will be noted, omits the specific provision of the Securities Act that reliance may be shown without proof that the plaintiff read the statement. This omission does not mean necessarily that proof of reliance requires proof of reading, but the omission may nevertheless render somewhat more difficult the maintenance of suits under Section 18. An apparent consequence of the reliance requirement is that if the plaintiff has purchased before the misstatement and has sold because of his own financial difficulties, he may not recover his loss on a security even if its decline in price was due to a misstatement in a document filed with the Commission.

The Exchange Act contains no rules for the measurement of damages. Whether the measure of damages provided in the Securities Act will be used or a common law measure of damages is still undetermined. Since some issuers of securities frequently must file documents under both the Securities Act and the Exchange

Act, an investor injured by a misstatement in two registration statements might have the option to sue under either act, and if the misstatements could be said to have caused different losses he might be allowed to sue under both acts. The Exchange Act, unlike the Securities Act, does not limit damages to the sum at which the security was offered to the public. Under the Securities Act an injured person might recover part of his loss, and obtain the balance as the result of a suit under the Exchange Act.

II

The investor or speculator may not only suffer from the lack or inaccuracy of information, which may enable him to form a judgment of the intrinsic merits of securities, but may also be deceived as to relative values of securities by misleading impressions gained from the volume of transactions or the upward or downward tendencies of prices. Too great facilities for speculation may tempt the unwary into unwise commitments in circumstances where minor fluctuations of prices may cause him irremediable damage. So far as security trading concerns the larger aspects of credit and financial policy, the Exchange Act invests the Federal Reserve Board rather than the Securities and Exchange Commission with administrative authority. Section 7, for example, dealing with margin requirements, is administered by the Federal Reserve Board and Section 8, dealing with broker's borrowing, is largely, but not exclusively, administered by the Board. These sections, although designed primarily to safeguard the nation's banking structure, do afford considerable protection to traders in securities. Not the least of this protection is a protection to the traders from themselves.

The Exchange Act in Section 5 forbids brokers, dealers and exchanges from using the mails or the instrumentalities of interstate commerce in employing the facilities of any exchange not registered as a national securities exchange, unless it is excepted by the Commission. Section 6, as has been mentioned, provides for the registration of national securities exchanges. The Commission is given broad powers of prescribing the information it desires from exchanges. Section 11 gives the Commission power to regulate and prescribe the functions of the members of the exchanges, to regulate or prevent floor trading, and prevent excessive trading by members, and to regulate odd lot dealers and specialists. A member who is a broker and dealer of a securities exchange may not carry for his customers on margin directly or indirectly a security which was part of a new issue in the distribution of which he participated as a member of a selling syndicate within six months. Likewise, a broker who is also a dealer may not make a purchase or sale for or with a customer unless he discloses to the customer in writing at or before the completion of the transaction, the capacity in which he is acting. The general purpose of all these provisions is to assure to the investor and trader in securities as reliable information as possible about market conditions, as well as a convenient, accessible and honestly conducted market.

Section 9 forbids any person by the use of the mails or any instrumentality of interstate commerce to employ the facilities of any national securities exchange to create artificial prices. Wash sales, matched orders, rigging the market, dissemination of information about market activity for the purpose of affecting the price of securities, and the issuance of false and misleading statements regarding securities are categorically prohibited. Pegging or stabilizing prices, puts, calls, straddles and other options are unlawful except to the extent permitted by the regulations of the Commission.

Section 10 forbids short sales or stop loss orders of securities registered on a national security exchange except as such transactions are allowed under the Commission's regulations. In addition Section 10 contains a blanket provision forbidding any manipulative or deceptive devices in contravention of the rules and regulations of the Commission. The resourceful and unscrupulous traders who think up schemes not specifically condemned by Section 9 thus find themselves at best only one jump ahead of the Commission.[22]

III

The Exchange Act in addition to Section 11, imposing civil liability for misleading statements in registration statements, periodical reports and other documents, contains numerous provisions designed to prevent violations and to give redress to parties ignored by such violations. The Commission upon complaint or on its own initiative may investigate possible violations of the Act,[23] may conduct inquiries at which it can compel the attendance of witnesses,[24] may sue to enjoin threatened violations,[25] may bring mandamus to compel compliance,[26] may suspend or withdraw licenses to exchanges,[27] may alter the rules of exchanges,[28] and may for brief periods suspend trading in registered securities.[29]

Wilful violation of the provisions of the Act or of rules properly issued thereunder is made a crime.[30] A person who wilfully engages in manipulative practices is made liable for damages to any person purchasing or selling a security at a price which was influenced by manipulative practices.[31] A person who controls another is made jointly and severally liable to the same extent as the controlled person, unless the controlling person acts in good faith.[32] Contracts in violation of the Act are void as are contracts binding any person to waive compliance with the Act or rules and regulations issued under it.[33]

[22] See Mathias, *Manipulative Practices and the Securities Exchange Act* (1936) 3 UNIV. OF PITTSBURG L. REV. 7, 105; TWENTIETH CENTURY FUND, INC., THE SECURITY MARKETS (1935) 444.

[23] Securities Exchange Act, §21(a). See Comment, *Investigatory Powers of the Securities and Exchange Commission* (1935) 44 YALE L. J. 819.

[24] Securities Exchange Act, §21(b), (c), (d).

[25] *Id.*, §21(e).

[26] *Id.*, §21(f).

[27] *Id.*, §19(a), (b).

[28] *Id.*, §19(b).

[29] *Id.*, §19(a)(4).

[30] *Id.*, §32. See Herlands, *Criminal Law Aspects of the Securities Exchange Act* (1935) 21 VA. L. REV. 139.

[31] Securities Exchange Act, §9(e).

[32] *Id.*, §20.

[33] *Id.*, §29.

From this brief outline it is perhaps apparent that, admitting the desirability of the Securities Act, it is nonetheless essential that it be supplemented in important particulars by the Exchange Act. It might be preferable indeed if many of the features of both acts were a part of one statute instead of two. Certain inconsistencies between the two acts remain to irritate those subject to them and to complicate the task of the Commission. To some extent the Commission is eliminating those by its regulations; as to others the Commission will doubtless in the future be able to suggest clarifying changes. While not all that the Commission has done has met with universal approbation it has thus far exhibited, at least in matters primarily affecting the protection to investors, an attitude of continuous watchfulness after the investor's interests that has accumulated for it considerable assets of public good will. Few will be bold enough to regard the Securities Act and the Exchange Act as temporary or to look upon the Commission as anything but a permanent factor in the financial community.[84]

[84] Critics of both the Securities Act and the Securities Exchange Act argue that these Acts and the Commission's regulations under them require the filing at great cost and inconvenience of statements and reports so detailed and extensive that no investor may be expected to make any examination of them and that few investors could comprehend them even if examined. While the Commission may keep certain information secret, most of the reports to it are available to the public, either to examine or by obtaining copies of filed documents by paying the cost of duplication. The ordinary investor relies upon the advice of investment services whose experts are presumably competent to analyze even the reports filed with the Commission. A considerable number of the items found in filed documents, especially when these are summarized in the Commission's press releases and reports, find their way into the financial columns of daily and other newspapers, and provide even the casual investors with much usable information. It is quite possible, however, that a considerable simplification of the Commission's requirements might occur without materially decreasing the protection now enjoyed by the public. The Commission's tendency at the moment is to increase, rather than diminish, its authority over trades and trading practices. There is no real evidence that public opinion yet desires a lessening of the Commission's activities.

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* As used in this index, the abbreviation "S. Act" refers to the Securities Act of 1933, "S. E. Act", to the Securities Exchange Act of 1934, and "S. E. C.", to the Securities and Exchange Commission.

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